

WARNING TO THE READER

The format of this outline is, to some extent, governed by and reflects the character of the subject matter:- not necessarily internally totally consistent, uniform, coherent or complete.

VERSION OF

JANUARY 15, 2009

ACKNOWLEDGEMENTS – I AM GRATEFUL FOR THE ASSISTANCE OF ALEXANDRE GENEST AND BRANDON WIENER OF DAVIES WARD PHILLIPS & VINEBERG LLP, FOR RESEARCHING CERTAIN & ANALYZING CERTAIN ASPECTS OF THIS PAPER

THIS DRAFT IS NOT FULLY:

- complete
- vetted
- edited

A final version will be made available no later than February 23.

2009 IFA TRAVELLING LECTURESHIP

MONTREAL/OTTAWA/TORONTO (JANUARY 2009)

CALGARY/VANCOUVER (FEBRUARY 2009)

TAXATION OF ROYALTIES IN AN INTERNATIONAL SETTING

OUTLINE

NATHAN BOIDMAN

DAVIES WARD PHILLIPS & VINEBERG LLP

Table of Contents

SECTION I - INTRODUCTORY MATTERS.....	6
A. Overview.....	6
B. Structure or Lecture and Core Factors.....	10
SECTION II - COMMERCIAL LAW	15
A. Overview.....	15
B. Non-Tax Statute Definitions?	16
C. Canadian Courts.....	17
D. Does a royalty necessarily imply an underlying “license”?.....	17
E. Underlying Property Necessary?	18
F. Bundled Transactions.....	18
G. Natural resources - related?	18
SECTION III - TAX LAW – DOMESTIC TRANSACTIONS.....	18
A. Does tax law depart from or augment commercial law notions of royalty?.....	18
(1) In Canada?	18

(2)	Elsewhere?	19
B.	Treatment of parties to royalty-licence contract	19
(1)	Overview	19
(2)	Illustration and Basic Questions	20
(3)	Governing Principles	22
(4)	Suggested Answers to the Questions Raised	25
(5)	Other Points	33
C.	The Checkered History Of Paragraph 12(1)(g).....	33
D.	CCPC's and ITA section 125/129.....	34
E.	Transactions in Royalty Producing Property Rights.....	35
(1)	Overview	35
(2)	Sale/Purchase of Such Property	36
(3)	Cancellation of Right/Licences.....	36
(4)	Elsewhere.....	37
F.	Other?.....	37

SECTION IV - TAX LAW – CROSS-BORDER – ARM'S LENGTH LICENCES38

A.	Cross-border Transaction-Inbound Provision of Things or Services and OutBound Payments	38
(1)	Two Regimes	38
(2)	Departure from Commercial Law?	38
(a)	Where Part I applies	39
(b)	Where Part XIII applies? – The relevant definitions.....	39
(3)	How is (foreign) recipient treated in Canada? – Part I	41
(a)	Domestic – Part I.....	41
(b)	Treaty – Part I.....	42
(c)	Provincial?.....	42
(4)	How is (foreign) recipient treated in Canada? – Part XIII.....	42
(a)	Domestic – Part XIII	42
(i)	Basic (ITA paragraph 212(1)(d)).....	42
(ii)	ITA subparagraph 212(1)(d)(i)	45
a)	The Statute and Overview	45
b)	Threshold Context.....	47
c)	A Threshold Issue – “use” versus “alienation or sale”	48
d)	Second Threshold Issue – “bundled” transactions.....	50
e)	Third Threshold Issue – The role of terminology in a contract.....	51
f)	Fourth Threshold Issue – Nature or Ambit of “Property”	51
g)	The Case Law:	52
i)	<i>Saint John Shipbuilding</i>	52
ii)	<i>Farmparts</i>	57
iii)	<i>Grand Toy</i>	59
iv)	Other Countries on <i>Saint John</i> ?	62
h)	Distributors and Saint John and the Ancillary Notion of Shrink Wrap	64
(iii)	ITA subparagraph 212(1)(d)(ii)	67
(iv)	ITA subparagraph 212(1)(d)(iii).....	68

(v)	ITA subparagraph 212(1)(d)(iv)	81
(vi)	ITA subparagraph 212(1)(d)(v)	82
(vii)	Surrogatum Principle – “In Lieu of Payment”	83
(viii)	The proposed section 56.4 in the cross-Border (Part XIII) context	84
(ix)	Exemptions and special cases under paragraph 212(1)(d).....	87
a)	Copyright – Implications for <i>Saint John Shipbuilding</i>	87
b)	Special rules for films, etc.....	90
(x)	Franchising.....	91
(xi)	Other Matters	94
(xii)	The Future of Part XIII and the December 10, 2008 Recommendations of the Advisory Panel on Canada’s International Tax System	95
(b)	Treaty – Part XIII	95
(i)	Thrust of Basic Canadian Treaty Policy and OECD Nexus	95
(ii)	OECD Model	96
a)	Canada’s position on the Model – in general.....	96
b)	Basic OECD Position – Article 12:.....	96
c)	Basic OECD Definition	97
d)	Basic Source Rules	97
e)	Position on Software and The 2008 Revised Commentary	97
(iii)	Canada.....	100
a)	Basics	100
b)	Definition of Royalties (and Influence – Effect of OECD – in General)	101
c)	Definition of Royalties in Relation to Software – shrink wrap and similar.....	101
d)	Definition of Royalties - <i>Saint John Shipbuilding</i> – related	102
e)	Sourcing Rules	102
f)	Beneficial Owner – Treaty Shopping and All That	103
g)	Some Notes on Issues for “Withholding Agents”.....	104
(5)	Elsewhere.....	107
(a)	Domestic.....	107
(b)	US Treaty	107
(c)	UN Expansive Notion	107
(6)	Transactions in Royalty Producing Property	107
(a)	Context	107
(b)	Part I – Nexus/Factors	107
B.	Cross-border outbound (third party) license and inbound royalty.....	108
(1)	Overview.....	108
(2)	How are foreign tax credits handled?	109
(a)	In Canada.....	109
(i)	The “Credit” Rules of ITA Section 126.....	109
a)	The Basic Dichotomy of ITA Section 126 and How It Connects to Foreign Royalties	109
b)	ITA subparagraph 126(2)(2.1) – Foreign Business	110
c)	ITA subsection 126(1) – Foreign (“Source”) Royalty	110

d)	The Nature of the Credit Provided by ITA subsection 126(1) – (and No Carry-Overs).....	110
e)	The Nature of the Credit Provided by ITA subsection 126(2) and (2.1) (and Carry-Overs).....	111
(ii)	The “Deduction” Rules Under ITA subsections 20(11) and (12)....	111
a)	ITA subsection 20(11)	111
b)	ITA Subsection 20(12).....	112
(b)	Elsewhere	112
C.	Canadian-owned foreign entity royalty earners involving third-party licencees-payors.....	112
(1)	The Multiple Contexts and Background	112
(2)	CONTROLLED FOREIGN AFFILIATES – ACTIVE BUSINESS INCOME – FOREIGN ACCRUAL PROPERTY INCOME.....	112
(a)	Basics	112
(b)	FAPI – INVESTMENT BUSINESS – Royalties – <i>Saint John</i>	114
(c)	ITA paragraph 95(2)(a.3) – Trap.....	116
(3)	ITA section 94.1.....	117
SECTION V - CROSS-BORDER INTERCOMPANY		118
A.	Cross-the Canadian border.....	118
(1)	Section 247 transfer pricing matters	118
(a)	Royalties under licenses	118
(i)	Inbound Licenses – Outbound Royalties	119
a)	Other Countries.....	120
b)	Consequences of Outbound Royalties Not Comprising ALPs	121
(ii)	Outbound Licenses – Inbound Royalties	121
(b)	Transfers of ownership of intangibles - outbound	122
(i)	General considerations.....	122
(ii)	ITA paragraph 247(2)(b) Recharacterization.....	123
a)	Basic Ambit – Inscrutable.....	123
b)	Situations: Merck, Gildan, MacIsaac.....	124
(iii)	A variation on the theme – the OECD and Business Restructurings	125
(c)	Transfers of Ownership – Inbound.....	126
(d)	Bundled transactions	126
(e)	Cost sharing arrangements	128
(2)	Additional Part XIII issues.....	129
(a)	Related to ITA section 247.....	129
(b)	Related to ITA section 78.....	130
B.	Foreign intercompany licensing arrangements	131
(1)	ITA subparagraph 95(2)(a)(ii)	131
SECTION VI - ELECTRONIC COMMERCE		132
A.	Overview and Correlation to Foregoing	132
B.	THE AMBIT OF E-COMMERCE AND Commercial Law Aspects.....	136
C.	Cross Border – Arm’s Length.....	138
(1)	Inbound Transactions – Outbound Payments	138

(a)	Overview	138
(b)	Part XIII – Related	139
(2)	Outbound Transactions – Inbound Payments	143
(3)	Involving Foreign Investees.....	143
D.	Cross Border – Intercompany	144
SECTION VII - RELATED CONTRACTUAL MATTERS.....		144
SECTION VIII - APPENDICES		145

SECTION I - INTRODUCTORY MATTERS

A. OVERVIEW

When I was asked to do this lecture, I had two reactions. First, I owed it to King Freddie to do it. Who is King Freddie? Let me explain [...] My second reaction was that after 37 years of tax practice, including some extensive file exposure to the mysteries of paragraph 212(1)(d) of the *Act*¹ - [particularly subparagraph (i), which purports to tax just about anything that moves and its incomplete interpretation in the landmark case of *Saint John Shipbuilding – infra note •* - (involving a lump sum payment by a Canadian to a U.S. party for the right to use, in perpetuity, computer programs to build ships, but where the Canadian had no right to on-sell or alienate the computer programs received), as well as doing various related writings (including paper on E-Commerce) it would be a walk in the park.

In fact, that was/is partially true in respect of the lecture itself. I probably could have done it with relatively little preparation. But preparing and providing a cogent set of lecture notes proved to not only be a much bigger challenge, and much more time-consuming than I thought, but more relevant, opened my eyes to a number of important factors and issues which I had never come across and therefore had never thought about. And in that respect, doing this lecture—like any writing or speaking project—has been, for me, both a voyage of discovery and a salutary learning experience.

What is this lecture all about? --Simple fare? Today, the modern, ordinary way of looking at the word “royalty” and its meaning is, in my view, to cite the minority decision of Mr. Justice Locke

¹ Income Tax Act (Canada), R.S.C. 1985, Chap.1 (5th supp.), as amended (herein “the Act” or “ITA”).

in the Supreme Court's 1952 decision in *Wain-Town*, where he wrote: • "...” That resonates with the ordinary “commercial” (non-tax) meaning ascribed by the court in a tax case which adopted Black's Law Dictionary: -

“Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, or to an investor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property. In its broadest aspect, it is share of profit reserved by owner for permitting another the use of property. [...]

In mining and oil operations, a share of the product or profit paid to the owner of the property.”

Simple, straightforward? Unfortunately, it turns out that the relevant meaning of the word “royalty” or the statutory proxies for it (necessitated, in some cases by the absence of the word itself) and the taxation thereof (both domestically and internationally) is anything but simple and straightforward. It is, in fact, a very slippery matter and there are several reasons for that.

First, strangely the word does not even appear in the main part of our domestic tax law – that is, that portion applicable to Canadians who directly engage in transactions involving royalties (that is, under Part I of the Act). In particular, the word “royalty” only appears in Part I in relation to the rules for transactions by foreign entities in which Canadians have interests—that is, in and for the CFA², FA³, FAPI⁴ rules and in current and proposed sections 94.1(?)

² Controlled foreign affiliate, per subsection 95(1) ITA.

³ Foreign affiliate, per subsection 95(1) and (4) ITA.

⁴ Foreign accrual property income, per subsection ..., ITA

Second, the development of the use of the word was in totally different contexts than that now of modern business—namely, that related to the mineral resource industry and sector and most importantly, not in relation to transactions which conveyed mere use—but to those that transferred total ownership. There is a convoluted history here (well told, in an 1999 *Canadian Tax Journal* article by Duncan Osborne – see Appendix 2). The Privy Council, in my view, got it right in 1933 in the landmark case of *Spooner*⁵, when it rejected the notion that the word “royalty” should apply to payments made as part of the consideration for a total acquisition of property—even where those payments are contingent on the use and profitability by the purchaser of the property. But the Canadian government did not like that result, so it bastardized the natural meanings and principles by enacting the original predecessor to today’s paragraph 12(1)(g) of the Act—which picks up both:

- “royalty” as we understand them today; and
- payments to satisfy consideration for total acquisitions.

Third, to further complicate the matter, our courts misinterpreted paragraph 12(1)(g) by applying to it something different than intended, where (1) the price for the acquisition is fixed and not contingent, (2) the fixed price must be paid ultimately, but (3) the timing of payments or amounts of payments during the course of the payout period may be dependent upon use by the acquiror.⁶

⁵ *Spooner* (Ex. Ct.) (1), 196; (P.C.) (1) 258; (S.C.C.) (1) 211.

⁶ (The cases). One of the problems is that the original rule to counter *Spooner*—section 3(1) - used (unlike present paragraph 12(1)(g)) the word “royalty” in its formulation. (The intermediary rule, between the first and the current section 6(1) did not use that word.)

Fourth, at the other extreme from Part I, Part XIII of the Act not only uses the term “royalty”, but has a series of rules which seek to apply the same tax result as when a natural royalty is paid to a non-resident, to transactions which – in whole or in part - do not entail or involve the notion of royalty. Elements of the extended rules may reach payments which lack (by reason of their character or the character of the consideration received for which they are being made) the essence of the royalty (or rent) such as a fixed payments for perpetual use of rights, contingent payments where no property, and, therefore, no use of property is involved, but instead, services have been performed or information provided or where they are in consideration of full grant of rights or where they relate to restrictive undertakings.

Here, a major issue is that the courts chose (in *Farmparts* and noted in *Hasbro*) (but did not fully decide in *Saint John*) to adopt an interpretation of subparagraph 212(1)(d)(i), which arguably may be textual, but not contextual or purposively correct. This is examined at length below.⁷

Fifth, in treaties, matters become even more arbitrary in that the typical Article 12 provision has a definition of “royalties” which simply ignores any natural meaning of that term and, instead, simply reflects certain particular objectives or views of the draftsman. In other words, the definition can be different in every separate treaty⁸. That’s just to keep us on our toes.

⁷ Subparagraph (iii) clearly overrides the notion (seen, *inter alia*, in *Hasbro*) and in a section 125 case that the notion of royalties cannot be related to provision of services. See certain comments to that effect in Duncan’s article.

⁸ Canada, for example, departs from the OECD by adding in the separate notion of rents for use of tangibles.

Sixth, returning to FAPI, where the word “royalty” is used, we will see that the absence of a definition and the foregoing (and the potential impact of the decision in *Saint John*) in light of certain statutory words, clouds the picture.

What is the bottom line with respect to the meaning of “royalties”?

- (a) In Part I, a definition does not matter, because except with respect to FAPI and section 94.1, the word is not used.
 - (i) Here further consideration is required for the role of *Saint John Shipbuilding*.
- (b) In Part XIII, a definition is, in a way, largely irrelevant, because of the extra rules (e.g. subparagraph 212(1)(d)(i) et al.) probably give the same overall tax result as where the word “royalty” were defined in the broadest way possible – one far beyond its natural and normal current meaning.
- (c) Then there is the e-commerce add-on where, at least in Canada, the *Saint John Shipbuilding* case is a perfect segue between “bricks and mortar” and cyberspace.⁹

B. STRUCTURE OR LECTURE AND CORE FACTORS

“Taxation of Royalties-----”: - a relatively straightforward notion? Not quite. Not even in the “bricks and mortar” era. Certainly not in the software and related, but separate, “e-commerce” era, which sees a plethora of virtual or synthetic notions and transactions complicate the

⁹ But there also is the oddity here that that matter was the object of much writings during the period 1996-2003, but since there appears to be very little on point.

landscape. And even if relatively so in a purely domestic setting (in either era), definitely not in the international setting - particularly in the current era.

This lecture will examine the issues and difficulties suggested above, within the context drawn by the following parameters.

- Threshold Commercial Law Aspects;
- Tax Law:-
 - Domestic Transactions;
 - Cross-border-arm's length transactions
 - Inbound
 - Outbound
 - Those involving foreign investees
 - Cross-border - Intercompany and Other Non-Arm's Length Transactions
 - Characterization Issues
 - Pricing Issues
 - Unpaid amounts and sections 78 and 212 of the Income Tax Act
 - Inter-affiliate and ITA subparagraph 95(2)(a)(ii)
- Electronic Commerce (and Looking at Applicable Foregoing Elements)

- (Software – considered in (during) the discussions above – will be a bridge and segue to royalties in e-commerce)

The international focus will be developed in the context provided by a juxtaposition of the Canadian domestic, cross-border and treaty rules with comparative notions and developments in a number of other countries. This will necessarily draw upon, and draw out, the threshold role, influence and affects of multilateral initiatives - primarily but not only those at OECD.¹⁰ (Clearly the advent of both the pan European (EC)¹¹ initiatives and directives and the interventionist decisions of the ECJ¹² is of interest in Canada and other countries which are not a part of the EC.)

Designed to treat the topic from the perspectives (and interest) of both the new entrant in the field of international tax practice and the grey beards in this arena, the lecture's main constraint might well only be that there is only a morning available, not a full day or two, to address the wide number and variety of factors and issues bound up in the subject matter.

The second to last section (on intercompany and other non-arm's length) could obviously be the object of, and absorb, the entire lecture - and that leaves the section on inbound arm's length as the logical focal point of the lecture – as, aside from the former, it raises the most pervasive (and broadest range of) issues on an ongoing basis. That focal point is grounded in an understanding of four basic inter-related factors.

¹⁰ Organization for Economic Cooperation and Development (...)

¹¹ European Union or European Community [To put a note from ...]

¹² European Court of Justice (...)

- First, when tax law refers to “royalties”, what is the natural (i.e. commercial (not tax) law) meaning thereof?
 - See Section II
- Second, when does tax law extend or otherwise redefine “royalties”?
 - This is not seen in the *Act*
- Third, when does tax law TREAT a payment—not otherwise a royalty under the prior two - in the same or similar fashion that it treats a royalty?
 - As already noted, this is a specific objective in Part XIII
- Fourth, how does tax law treat transactions in royalty-producing rights?
 - This is not a pre-occupation

In order to arrive at a discussion of those questions—and the tax consequences that result—with respect to the focal point of our topic (inbound cross-border arm’s length) we have a natural progression through three stages -

- first, examining the purely commercial (non tax) law context (on which the domestic situations and cross-border will lever)
- second, examining the effect of the latter on the purely domestic tax situation (on which the cross-border situations will lever)
- third, examining the effect of the latter on the cross-border tax situation and the addition rules and considerations that arise therein.

So let's embark on this natural progression, but examining and filtering the matter thru two pervasive interrelated underlying concepts.

The first concept is that "royalties" normally arise in the context of an arrangement whereby one party gives another the right to use something for a certain period time. (But then, the same can be said about the different term "rents" – see below.)

The second concept is that, conversely, "royalties" do not arise where the full incidences of ownership are transferred.

Then there are five subordinate-ancillary concepts.

- The first is that in some cases where full ownership are transferred, the method that the price therefore is calculated may see tax treatment in a manner akin to that where a "royalty" is paid.
 - See, for example, below, paragraph 12(1)(g) and subparagraph 212(1)(d)(v).
- The second is that some situations are characterized by arrangements which see a hybrid type of right delivered --more than a use for a stipulated period of time, but less than a full conveyance of all rights-- as arose in the landmark decision in *Saint John Shipbuilding* which we will be examining at length in the focal section of the lecture.
- The third is the nature of a transaction which sees a payment made upon a termination of a pre-existing "licence" (pursuant to which "royalties" were being paid).
- The fourth is an outright sale of property rights which are subject to an existing "royalty" paying "licence".

- The fifth is a “sale”-type transaction for rights pertaining to a geographical area (including rights to be a distributor and (associated) rights conveyed by agreeing to refrain from doing something (e.g. proposed ITA section 56.4).

(Some of these areas require, for thorough examination, a lecture of their own--including, obviously the 56.4 matter.)

Now on to Section II--”Commercial”, bearing in mind the role it plays in considering tax considerations.

SECTION II - COMMERCIAL LAW

To the extent that the word “royalty” and its meaning does matter, the starting point to give it meaning – given that it is not defined in the *Act* - would be reference to its meaning in commercial law.

A. OVERVIEW

Since tax law treats property and property rights and income derived therefrom on the basis of their meanings under the commercial laws or contracts that govern them - unless specific derogation or augmentation thereof—our starting point is to consider the meaning and ambit of “royalties” - and related matters under non-tax (i.e. “commercial) law.

What are the key characteristics of a royalty under commercial law? There appears to be three broad possibilities, and an added factor.

- First, perhaps it is a payment by one person to another that is calculated in a certain way, regardless of the consideration delivered by the recipient.

- But, as discussed below it appears to require “property”.
- Second, or perhaps it is a payment related to the delivery of a certain type of consideration, regardless of how it is calculated or determined.
 - But as discussed below it appears to require dependency/contingency of payment.
- Third, or perhaps it is a payment which is characterized by elements of both of the first two factors.
 - This does appear to be the case.
- Fourth, it appears to require that the property delivered to the payor be returned to the payor at the end of the arrangement.

The foregoing should indicate the nature of the underlying type of transaction that gives rise to a royalty and the type of underlying contract that will be involved.

B. NON-TAX STATUTE DEFINITIONS?

- There appears to be none of common or widespread use¹³.

¹³ Indeed, some statutes define royalties by expanding upon an undefined base. (See, for example, the *Defence Production Act*, R.S.C. 1985, c. D-1), which reads as follows:

“royalties” «*redevances* » royalties” includes

(a) licence fees and all other payments analogous to royalties, whether or not payable under any contract, that are calculated as a percentage of the cost or sale price of defence supplies or as a fixed amount per article produced or that are based on the quantity or number of articles produced or sold or on the volume of business done, and

(b) claims for damages for the infringement or use of any registered topography within the meaning of the *Integrated Circuit Topography Act* or of any patent or registered industrial design;

C. CANADIAN COURTS

Canadian Courts have adopted legal dictionary definitions as the base. See *Mobile*¹⁴ (Appendix ●), which, although a tax case, adopted, in paragraphs 17 and 18, for commercial law purposes Black's Law Dictionary as follows.

17 The Income Tax Act does not define "royalty", and there is no jurisprudence that offers a comprehensive definition. Mobil relies on the following definition, which appears in Black's Law Dictionary, 5th ed. (St. Paul, Minn: West Publishing Co., 1979) at page 1195:

Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, or to an investor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property. In its broadest aspect, it is share of profit reserved by owner for permitting another the use of property. [...]

In mining and oil operations, a share of the product or profit paid to the owner of the property.

18 It is common ground that this definition is appropriate to describe the Canadian usage of the word "royalty" in the commercial context" (underscore added).

D. DOES A ROYALTY NECESSARILY IMPLY AN UNDERLYING "LICENSE"?

- Is this circular (e.g. what is a "license") or irrelevant because "license" is simply a label given to a contract involving the use of intangibles? What is the significance of the use of the word : "license"?¹⁵

[...]

¹⁴ *Mobile Oil Canada Ltd. v. Canada*, [2001] FCJ No. 1656 (F.C.A.), 2001 DTC 5668.

¹⁵ As in the case of the use of the word "royalties" the terminology employed will not turn a cat into a dog – although it will be accorded some weight. See the FCA in *Saint John Shipbuilding*, below.

E. UNDERLYING PROPERTY NECESSARY?

Does a royalty necessarily imply/require underlying property or can it be paid for services?

- There is no developed royalty notion respecting services and the definitions above clearly require property.

F. BUNDLED TRANSACTIONS

Payments made for a bundle of things – use of intangibles, for services, for know-how, etc., may give tax practitioners grey hair, but pose no particular commercial law issues.

- No commercial law notions/issues

G. NATURAL RESOURCES - RELATED?

(Not focus of lecture - needs separate lecture - raises real right platform.)¹⁶

SECTION III - TAX LAW – DOMESTIC TRANSACTIONS

A. DOES TAX LAW DEPART FROM OR AUGMENT COMMERCIAL LAW NOTIONS OF ROYALTY?

(1) In Canada?

There is no (general) statutory use of the term, for domestic transactions and thus, of course, no definition.

- Exceptions?
 - See below re: FAPI

The more generic notion of “income from property” or “income from carrying on business” and related expenditure side notions would generally govern. That approach makes royalties indistinguishable from rent.¹⁷

(2) Elsewhere?

Some countries – e.g. Australia, Belgium and The Netherlands (but not ●) - statutorily use and define “royalty” – for general purposes of their tax law. These definitions may be quite expansive and do not necessarily reflect common themes or concepts seen in Canada.¹⁸

Certain other countries have limited-purpose definitions, such as the UK.¹⁹

B. TREATMENT OF PARTIES TO ROYALTY-LICENCE CONTRACT

(1) Overview

Royalties incurred to earn income from a business or property would normally be deductible pursuant to section 9 and paragraph 18(1)(a) of the *Act*. Leaving aside uncertainties potentially raised by paragraph 12(1)(g) – discussed below – royalty income would normally be recognized when realized, that is, on a “receivable” basis unless the payee is entitled to a “cash method” approach the underlying principals which are less than clear. Moreover, the popular term or

¹⁶ See, Osborne, page 425 (Appendix 2) for relevant comments.

¹⁷ But, in Part XIII the two are distinguished as discussed below. See, *Vauban Productions v. The Queen*, 79 DTC 5186; *Grand Toys Ltd. v. M.N.R.*, 90 DTC 1059; *Stepanoff, V. v. The Queen*, 06 DTC 2260.

¹⁸ See Appendix ● for some details.

¹⁹ There is a definition for purposes of taxation of corporate intellectual property and the EC interest and royalty directives.

terminology “cash” or “accrual” is misleading and/or simplistic as the comments below will indicate.²⁰

(2) Illustration and Basic Questions

For purposes of this discussion, consider the following illustration.

- Taxpayer1 (the “**Licensor**”) has a calendar taxation year end and owns an intangible property (a patent for example) that is licensed to Taxpayer2 (the “**Licensee**”) which uses the intangible in carrying on a business.
- A license agreement (the “**Agreement**”) is entered into by Licensor and Licensee on July 1, 2008, which requires from Licensee that he pay a 5% royalty per year of the Agreement on his sales. The royalties would be due on June 30, 2009, and would be so payable for every year in which the Agreement applies.
- The Agreement would require that Licensee pay the royalty amount within a 30-day window, *i.e.* before July 30, 2009.
- Licensor could be either an individual who owns the patent and licenses it while not carrying on business, a taxable Canadian

²⁰ “Cash” or “accrual” is misleading and/or simplistic. There is an amount paid. There is an amount due or owed (that is all requirements to have to pay have occurred). And there is an amount “accrued”, but not yet due or owed. These differing situations can be seen in the following illustration. But which governs? Does the answer differ by reference to whether licensee is using the licensed thing in carrying on business or instead to earn income from property?

corporation that owns the patent in a way that is not related to the business carried on by it, or a taxable Canadian corporation that holds that patent in the course of carrying on business. It appears that for income inclusion purposes, the fact that either an individual or a corporation would own the patent and that the patent would be owned either in the course of carrying on business or not would not make a difference regarding the income inclusion and expense deductibility rules, as section 9 and paragraph 18(1)(a) of the *Income Tax Act* (the “Act”) speak of “income from a business or property”. It may however impact the choice of the method of computing income as discussed below. [Requires review for possible inconsistencies.]

- If the following had occurred as at December 31, 2009:
 - Licensee owes \$10,000 of royalties to Licensor as of June 30, 2009;
 - On December 31, 2009, Licensee has not yet paid the amount owed as royalties and Licensor would therefore have a receivable in respect of the royalty amounts on year end; and
 - For patent year starting on July 1, 2009 and ending June 30, 2010, Licensee had generated sales of \$1,000,000 up to December 31, 2009 and therefore \$50,000 of royalties would have accrued but would not be yet due or receivable.
- Questions

- (a) Does Licensor which is carrying on a business have to include in its income for 2009 the royalties (\$10,000) receivable, owed since June 30, 2009, and still unpaid at year end?

- (b) Does such Licensor have to include in its income the accrued royalties (\$50,000) as at December 31, 2009, which are not yet due nor receivable?
- (c) Can the Licensor is not carrying on business use the cash basis for computing its income?
- (d) Can Licensee deduct the royalty payments that are owed but unpaid since June 30, 2009 from its income for 2009?
- (e) Can the Licensee deduct from its income for 2009 the royalties in the amount of \$50,000 that accrued as at December 31, 2008, but which are not yet due nor payable?
- (f) When are royalties “incurred” for purposes of subsection 78(1) of the Act?²¹
- (g) When are royalties “paid or credited” for purposes of subsection 212(1) of the Act?²²

(3) Governing Principles

The following factors would appear to govern the answers to these questions and have been mainly drawn from a 2001 paper (set out in Appendix 3) to the Canadian Tax Foundation by Geoffrey Walker.²³

- From the point of view of Licensor, the general rule in respect of including royalty payments in income is found in paragraph 12(1)(g) of the Act. However, this provision only targets amounts

²¹ This question is deferred to section • .

²² This is deferred to section • .

²³ “Timing and recognition of income”, in *Report of proceedings of 53rd Tax Conference (2001)*, Canadian Tax Foundation, p. 29:1-29:54.

received by a taxpayer and would therefore not apply to the fact pattern discussed above.

- Paragraph 12(1)(b) of the Act applies to amounts receivable in respect of property sold or services rendered in the course of a business. Considering that royalties are paid for the use of property and not for the purchase thereof, and considering that royalties are not paid in exchange for services, paragraph 12(1)(b) would not apply to the fact pattern discussed above.
- We would therefore turn to the general rule found in subsection 9(1) of the Act: “[t]he principal that profit consists of the surplus of revenue for a year over the expenditure to earn that revenue has two aspects: first, the netting of revenues and expenses, and, second, the matching of revenues to the expenses incurred to earn them for a taxation year.”²⁴
- Underlying that statement are the following (according to Walker at 29:21):

[...]

7) To be recognized for tax purposes, an item of income must have attained the “quality of income.”⁶⁷

[...]

²⁴ Walker at 29:8.

Derivative Principles

[...]

2) Profits and losses are recognized when realized, subject to certain exceptions recognized in the cases.⁷¹

3) The use of the cash method is generally inappropriate for determining profit from a business except where permitted by the statute.⁷²

4) Revenues are generally realized when they are earned, (that is, when they become receivable, whether or not they are received immediately or in the future,)⁷³ and they are ascertained or ascertainable.⁷⁴

5) Revenues that are received are included in income in the year in respect of which the right of the taxpayer to the amount is absolute and under no restriction as to its disposition, use, or enjoyment.⁷⁵

[...]

10) Expenses are recognized when incurred—that is, when the taxpayer has an immediate and not contingent obligation to pay an amount, even if payment is not immediate.⁸⁰

11) Expenses are deductible in computing the profits of the taxation year to which they properly relate. This involves an inquiry into the specific facts to determine whether there is a causal link between a cost and specific revenues or benefits. If there is a direct link between costs and revenues, the costs are deductible in the taxation year in which the revenues are earned. If the expenditure is not referable to specific revenues or benefits arising in respect of a taxation year, and is part of the expenditure more generally incurred in running the business on an ongoing basis, it is deductible in the year in which it is incurred. If it is inconclusive on the facts as to which period the expense relates, the taxpayer is free to adopt an accepted accounting method of recognizing the expense unless the minister can demonstrate that another method provides a more accurate picture of income.⁸¹

12) Where there is a dispute between two methods of accounting, the method to be preferred is the one that is most appropriate to the facts of the business, is consistent with well-accepted business and accounting principles, is not inconsistent with the statute or case law principles, and provides the most accurate picture of

income by best describing, based on the known facts, the results of the income-earning process.⁸²

-
67. *Robertson v. Minister of National Revenue* (1944), 2 DTC 655 (Ex. Ct.). While this principle, as stated, appears to be a principle of computation, it is believed to be a foundation principle because it reflects the interpretation given the undefined term "income" that underlies the entire Act.
71. *Ostime v. Duple Motor Bodies Ltd.*, [1961] 2 All ER 167 (HL); *Canadian General Electric Co. Ltd. v. MNR*, 59 DTC 1217 (Ex. Ct.), rev'd. on other grounds, 61 DTC 1300 (SCC); and *The Queen v. Friedberg*, 93 DTC 5507 (SCC).
72. *Ken Steeves Sales Ltd. v. MNR*. 55 DTC 1044 (Ex. Ct.).
73. *MNR v. Colford Contracting Co. Ltd.*, 60 DTC 1131 (Ex. Ct.); *Ikea Limited v. The Queen*, 98 DTC 6092 (SCC); *Commissioners of Inland Revenue v. Gardner Mountain & D'Ambrumenil*, (1947), 29 TC 69 (HL); and *Ken Steeves Sales*, supra note 72.
74. *MNR v. Benaby Realities Limited*, 67 DTC 5275 (SCC).
75. *Robertson*, supra note 67; and *Dominion Taxicab Assn. v. MNR*, 54 DTC 1020 (SCC).
80. *Fédération des Caisses Populaire Desjardins c. La Reine*, 2001 DTC 5173 (FCA).
81. *The Naval Colliery Co., Ltd. v. The Commissioners of Inland Revenue* (1928), 12 TC 1017 (HL); *Associated Investors*, 67 DTC 5096 (Ex. Ct.); and *Canderel Limited v. The Queen*, 98 DTC 6100 (SCC).
82. *MNR v. Publishers Guild of Canada Ltd.*, 57 DTC 1017 (Ex. Ct.); and *Canderel*, supra note 81.

(4) Suggested Answers to the Questions Raised

Question (a): Does Licensor which is carrying on business have to include in its income for 2009 the royalties (\$10,000) receivable, owed since June 30, 2009, and still unpaid at year end? The answer appears to be yes based on derivative principle # 4 quoted in paragraph 11. However, the following case must be taken into consideration as it departs from this general principle.

- In *Boosey and Hawkes (Canada) Limited v. The Minister of National Revenue*, [1984] D.T.C. 1728 (T.C.C.), the taxpayer, which was in the music publishing business, was a member of a performing rights society which collected royalties from the users

of the various copyright involved and, after deducting its own costs, distributed the balance of the royalties to its members. The calculation of the royalties to which the taxpayer, as a member, was entitled was extremely complex and took many months to complete.

- As a result of this, the taxpayer did not receive royalties to which he was entitled in respect of the July to December 1978 period until June 1, 1979, before which date the taxpayer had no way of knowing the exact amount of royalties earned from July to December 1978. The taxpayer reported its royalty income on a cash basis and had done so for 20 years without objection from the tax authorities, although it accounted for its expenses on an accrual basis. This accounting approach prevailed throughout the music industry.
- The Minister of National Revenue (the “**Minister**”) included the amount received by the taxpayer on June 1, 1979 in its income for taxation year 1978, which led to the appeal of the taxpayer.
- The Court allowed the appeal of the taxpayer and found that although the royalty income was “receivable” in 1978, the taxpayer was nevertheless entitled to use the cash method of reporting this income. Even though the taxpayer was legally entitled to receive the amount by the end of 1978, and that all that remained was to

determine the exact amount, the cash method was viewed, from an accounting point of view, as proper and necessary and common to the music industry.

Question (b): Does Licensor have to include in its income the accrued royalties (\$50,000) as at December 31, 2009, which are not yet due nor receivable? The answer appears to be no based on derivative principle # 4 quoted in paragraph 11.

Question (c): Can a taxpayer use the cash basis for computing its income when it is not carrying on business? See the following excerpt of *528061 Ontario Limited et al. v. The Queen*, 95 D.T.C. 521 (T.C.C.) which raises the issue and in the end decides it without dwelling on the matter (and quotes David Ward):

The appeals of 608787 (facts and analysis)

The Appellant 608787 is a corporation that owns the premises in which the business carried on by 528061 and 528062 is located. The wives of Mr. John Rondelez (Sr.) and Mr. Jerome Rondelez (Sr.) were the shareholders and directors of this corporation. A lease was entered into on January 31st, 1988 between 608787, and 528061 and 528062. The annual rent was set for \$42,000 per year. This amount was never paid. In 1987 and in 1988, the amount of \$17,880 was paid and in the year 1989, the amount of \$17,930 was paid. The Appellant 608787 reported its income on a cash basis, whereas the tenants, 528061 and 528062, showed the full amounts each year as expenses.

At the hearing, both parties seemed to agree that the rental income should have been reported on an accrual basis without giving any reason except to say that it was required by the Act. That is true if the income is a business income but what if it is property income. There is a presumption that income from a corporate taxpayer is income from a business but this presumption is rebuttable (*Canadian Marconi Company vs. The Queen*, 2 S.C.R. 522). If it were income from a property, it is interesting to read what is said in Ward's *Tax Law and Planning*, vol. 2 at chapter 43.1 entitled 'Timing of inclusion of property income':

Although there is not a great deal of jurisprudence on the question, it is suggested that in light of the fact that sections 12(1)(a) and (b) are not applicable to income from property and that it was considered necessary to enact specific statutory rules requiring the accrual method to be used for interest income, income from property need not generally be computed on an accrual basis. In each case,

however, it would be necessary to establish that the cash method was appropriate for computing the profit from the property in accordance with the ordinary principles of commercial practice. In view of the fact that in most cases a taxpayer deriving only income from property would not have to be concerned with items such as inventory or significant accounts receivable, it would appear to be clearly arguable that the cash method is the most appropriate for the computation of such profit.

Since the point was not made by either counsel, there is no need to discuss this aspect any longer. Counsel for the Appellants said that, had the income been reported on an accrual basis, as he thought it should, a reserve for doubtful debt pursuant to paragraph 20(1)(l) of the Act would have been asked for by 608787 because 528061 and 528062 were not in a financial position to pay the full amount. Therefore in the end, he stated, the total taxable income would have been the same. Counsel for the Appellants also submitted that section 78 of the Act deals with amounts in respect of a deductible outlay that is owing by a taxpayer to a person with whom the taxpayer is not dealing at arm's length. This amount so unpaid shall be included in computing the taxpayer's income for the third taxation year following the taxation year in which the outlay or expense was incurred.

In the Reply to the Notice of Appeal, it is shown as a fact assumed by the Minister in assessing 608787 that no claim for a reserve for unpaid rental income had been made by the Appellant. Should I infer from this that if 608787 had done so, it would not have been disputed by the Minister. Asked to comment on this aspect, counsel for the Respondent informed the Court that he could not say whether a reserve would have been allowed.

Consequently, I find that I was given no reason to dismiss the appeal of 608787 and it is therefore allowed.²⁵

²⁵ For a CRA view: Excerpt From *The Tax Window*, Report No. 205 pp. 9-10:

Recognition of Royalty Income

In *Banner Pharmacaps NRO Ltd. v. The Queen*, 2003 DTC 5642 (F.C.A.), the Court held that taxable dividends were included in income "when received, not when they are merely receivable". Relying on the combined application of paragraph 12(1)(j) and clause 82(1)(a)(ii)(A), the Court noted that "Banner was required to include the dividend in its 1996 income only if it received the dividend in that year". The decision at the Tax Court had incorrectly concluded that the dividends should be included in income on an accrual basis.

[underscoring added]

Question (d): Can Licensee deduct the royalty payments that are owed but unpaid since June 30, 2009 from its income for 2009? The answer appears to be yes based on derivative principle # 10 and 11 quoted in paragraph 11.

The issue the CRA was asked to comment on was whether the decision in *Banner* affected the CRA's view on the treatment of royalty income, which we commented on in WINDOW ON CANADIAN TAX '6716. As previously reported, it was the CRA's view that a taxpayer could not rely on paragraph 12(1)(g) to exclude from income a royalty, accrued in the taxpayer's financial statements, that had not been received.

It is the CRA's view that the decision in *Banner* "did not specifically address the inter-relationship between subsection 9(1) and paragraph 12(1)(g)" and, therefore, does affect the view previously expressed. The CRA also notes that proposed subsection 12(2.01) clarifies that paragraph 12(1)(g) does not provide for the deferral of amounts that would otherwise be included in income under section 9.

Technical Interpretation, Reorganizations and Resources Division

June 10, 2008 para.9553

Source:

CCH Tax/Federal Income Tax/News Tracker/Past NewsfTax WindowfTax Window Files/2008-027826117 ROYALTY INCOME - CASH V. ACCRUAL. Does the Federal Court of Appeal Decision of *Banner Pharmacaps NRO v The Queen* impact the comments contained in Document 2001-00723677 LANGINI)E DOCNUM 2008-027826117 REFDATE080610.

Question (e): Can the Licensee deduct from its income for 2009 the royalties in the amount of \$50,000 that accrued as at December 31, 2008, but which are not yet due nor payable? The answer appears to be no based on derivative principle # 10 and 11 quoted in paragraph 11. However, the following cases must be taken into consideration as they depart from this general principle.

- First: see the *Boosey* case discussed above.
- Second: a different approach was followed in *Corriveau v. The Queen*, 2006 D.T.C. 2583 (T.C.C.) (which quoted approvingly *Banner Pharmacaps NRO Ltd. v. The Queen* 2003 D.T.C. 245 (T.C.C.), affirmed by F.C.A. – [2003] F.C.J. No. 1440 and *Ken Steeves Sales Ltd. v. M.N.R.*, 55 D.T.C. 1044 (Exch. Ct.)), where the Court held that the taxpayer was not entitled to use the cash method in respect of rental income and that the taxpayer had to use the accrual method for computing his income. [Review and reconsider.]

Question (f): When are royalties “incurred” for purposes of subsection 78(1) of the Act? [To be relocated to Section • and elaborated and reviewed.] See derivative principle #10 quoted in paragraph 11 and the following excerpt of CRA Interpretation Bulletin IT - 109R2 – Unpaid Amounts (April 23, 1993):

(a) Debtor and Creditor on the Accrual Basis

Generally, where an unpaid amount exists between a debtor and creditor who are not dealing at arm’s length and both taxpayers account for income on the accrual basis, subsection 78(1) will not be invoked. An exception occurs where the

unpaid amount in question appears to be part of a tax avoidance scheme which, for example, may involve transactions such as

- claiming a reserve under paragraph 20(1)(l) or (n), or a deduction under paragraph 20(1)(p), or
- deferring tax under Part XIII of the Act where the creditor is a non-resident.

Also, subsection 78(1) will not be applied to the debtor taxpayer if an unpaid amount is reported as income in the year by a creditor who is on the cash basis of reporting income.

Question (g): When are royalties “paid or credited” for purposes of subsection 212(1) of the Act? [To be relocated to Section • and elaborated.] See the following excerpt of CRA Information Circular IC77 – 16R4 – Non-Resident Income Tax (May 11, 1992):

5. The words “credits” and “credited” cover any situation where a resident of Canada or, in certain cases, a non-resident (see 8 below) has set aside and made unconditionally available to the non-resident creditor an amount due to the non-resident such as where (a) a tenant or agent deposits rents in a bank account on behalf of a non-resident landlord; (b) a bank credits interest to the savings account of a non-resident; (c) an insurance or trust company deposits a pension or annuity payment in the bank account of a non-resident; or (d) the amount due is applied by the resident (or deemed resident) against an amount owing by the non-resident. When an amount is subject to tax under section 212, subsection 214(1) provides that the tax is payable on the full amount paid or credited without any deduction from the amount.

- See also following excerpt of *CRA Income Tax – Technical News No. 14* (December 9, 1998) and of *La Compagnie Minière Québec Cartier v. Minister of National Revenue*, 84 D.T.C. 1348 (T.C.C.) (quoted approvingly in *Mutuelle des Fonctionnaires du Québec v. Canada*, 97 D.T.C. 5030 (F.C. T.D.) and in *Gillette Canada Inc. v. Canada*, 2001 D.T.C. 895 (T.C.C.)):

Income Tax Technical News No. 14:

Meaning of “Credited” for the Purpose of Part XIII Withholding Tax

We have had several inquiries regarding the meaning of “credited” for purposes of Part XIII of the *Income Tax Act* (the Act) with respect to situations where

journal entries have been made to record accrued interest payable to a non-resident creditor in the Canadian payer's books and the accrued interest is payable on demand to a non-resident who does not deal at arm's length with the payer. The Department's most recent comments on this topic are found in our response to Question 48 of the 1991 Revenue Canada Round Table which reads as follows:

"As set out in paragraph 5 of Information Circular 77-16R3, question 17 of the 1984 Round Table, and question 84 of the 1986 Round Table, an amount is 'credited where a resident of Canada has set aside and made unconditionally available to the non-resident creditor an amount due to the non-resident.' An amount is unconditionally available to the non-resident person when the non-resident has the immediate right to receive the amount -- for example, when the amount is recorded in the payer's books and is payable on demand."

This response indicates that an amount is "unconditionally available" where the payable has been recorded in the payer's books and records. However, there has been some confusion as to whether the Department considers the recording of the payable by way of journal entry to constitute an amount that has been "set aside."

It is the Department's position that the mere recording of the payable by way of journal entry, regardless that such amounts are payable on demand and the debtor has the capacity to pay such amount if such payments are demanded, does not constitute "credited" for purposes of subsection 212(1) of the Act.

While, in general, we believe that, for an amount to be "credited," an amount must be set aside and made unconditionally available for the non-resident more or less along the lines of those examples described in paragraph 5 of Information Circular 77-16R4, each case should be decided on the basis of its own particular facts. This position would seem to be consistent with the decision in *Quebec Cartier Mining vs. the Minister*, 84 DTC 1348 (TCC).

Québec Cartier Mining:

The Court regards an accounting system as a means of describing commercial transactions. Was the legislator in using "credit" insisting on this form? -- or was he more concerned with substance?

The Court is inclined to accept the second alternative: and the substance of "credit" seems to be "an operation by which someone puts a sum of money at the disposal of someone else".

[...]

In short, the Court is of the view that a strict interpretation of s. 212(1)(b) leads to interpreting the word "credit" according to its substance, "making available to", and not according to the form of making an entry "on the right side of an account".

- See also following excerpt of IT - 109R2:

(d) Non-Resident Withholding Tax Requirements

There may be circumstances where an amount owing by a Canadian taxpayer is due to a non-resident with whom the taxpayer does not deal at arm's length, and if paid, the amount owing would be subject to non-resident withholding tax. In these circumstances, if an agreement pursuant to paragraph 78(1)(b) is filed for such an amount, the amount is subject to non-resident withholding tax at the time it is deemed to have been paid by the Canadian taxpayer. Where the agreement is filed within the prescribed time limits, it is not the Department's practice to levy a penalty or interest in respect of the withholding tax requirements provided that the amount of tax is remitted on or before the fifteenth day of the month following the month in which the agreement is filed. As subparagraph 78(1)(b)(ii) deems the amount owing to be a loan from the non-resident to the Canadian taxpayer, any subsequent payments made by the Canadian taxpayer on account of that indebtedness are regarded as loan repayments and, therefore, are not subject to non-resident withholding tax.

Also, the provisions of section 78 apply to a deductible amount owing to a non-resident who does not deal at arm's length with the Canadian taxpayer even though the amount, such as a copyright royalty, is not subject to non-resident withholding tax.

(5) Other Points

- [Is there mirror/symmetrical rule to ITA paragraph 12(1)(g) discussed below?
 - Probably not: Section 14 governs payor]

C. THE CHECKERED HISTORY OF PARAGRAPH 12(1)(G)²⁶

In certain cases the courts seemed to have misapplied the rule by misconstruing situations where only the timing of receipt was linked to performance or profitability realized by the buyer.²⁷

²⁶ ITA paragraph 12(1)(g) reads as follows:

12. (1) Income inclusions -- There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:

(g) **payments based on production or use** -- any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property, except that an instalment of the sale price of agricultural land is not included by virtue of this paragraph;

For prior versions: 1934-3(1) and 1948-6(1).

Note proposed subsection 12(2.01), which was included in former Bill C-10 suggests that section 9 is intended to supersede paragraph 12(1)(g). The proposal reads as follows:

"Paragraph [12](1)(g) does not defer the inclusion in income of any amount that would, if this section were read without reference to that paragraph, be included in computing the taxpayer's income in accordance with section 9."

This would be consistent with the CRA view discussed above, arising out of the case of *Banner Pharmacaps NRO Ltd . v. The Queen* (See CRA, Technical Interpretations, 2008-0278261I7 and 2001-0072367).

D. CCPC'S AND ITA SECTION 125/129

- A CCPC is entitled to the SBD of ITA section 125 with respect to royalty income in one of two situations.
 - One is where the royalty constitutes under the basic law (see above) income from business (not income from property) and a more than five full-time employee test is met (ITA paragraph 125()()).
 - The other is where royalty is not governed by the latter, but is paid by an associated (?) corporation in respect of which it is deductible in computing its income which constitutes (●) for purposes of ITA section 125. ITA subsection 129(6), in this case, recharacterizes the royalty as not constituting (●) for purposes of ITA section 129, but instead (●) for purposes of ITA section 125.

²⁷ This is analyzed at length by Duncan Osborne in his CTJ article (see Appendix 2). In particular, see the case of *Ross* (and *Wain-Town*, as well) discussed at page 413. Other cases rejected *Ross* and fortunately CRA also rejected *Ross*—see quote at page 419. For the modern definition of “royalty” by Justice Locke in his dissent in the case of *Wain-Town*, see page 420 of Duncan. For more appropriate decisions see, *Gingras*, *infra note ●*, *Hould*, 65 DTC 624 (TAB) and *Brosseau*, 86 DTC 1412.

- (●) Cases that deal with the small business deduction and royalties: in *Alamar Farms Ltd. v. Canada (Minister of National Revenue – M.N.R.)*, [1992] T.C.J. No. 725 (T.C.C.), the taxpayer carried on an active farming business on land that it owned. It also received royalties from producing oil wells located on its land which were operated by someone else. The Court found that the royalty income, which was completely devoted to the taxpayer's farming activities, was incident to or pertained to the taxpayer's active farming business, and therefore was not income from a specified investment business.
- In *Rogers v. Canada*, [1997] T.C.J. No. 2 (T.C.C.), the taxpayer could claim a capital gains deduction for revenues attributable to the disposition of shares only if the shares were those of a small business corporation, more than 50% of the value of the assets which were attributable to assets used in an active business. The corporation's only real asset was a shopping mall and almost all of its revenue came from rent. It was held that the corporation's principle purpose was to derive income from property, that it carried on a specified investment business and therefore was not carrying on an active business.
- Another interesting case that is mentioned only for information purposes is *Luigi Tiengo Art & Design Inc. v. the Minister of National Revenue*, [1991] D.T.C. 1216 (T.C.C.), where it was held that the taxpayer did not receive royalties *per se*, even though a percentage method was used to calculate its revenue, but rather that the income was earned by the provision of design and other related services to the manufactures forming his client base. Such income was therefore being derived from an active business and qualified for the small business deduction.
 - See (included) – sale of shares
 - See (included) – royalties and services!!!

E. TRANSACTIONS IN ROYALTY PRODUCING PROPERTY RIGHTS

(1) Overview

No discussion of “royalties” could be complete without at least some reference to the tax considerations relevant to transactions involving royalty-producing property – that is its buy/sell

or cancellation of interests therein. In the domestic context, the usual issues arise. For the seller/recipient of consideration for the transaction or event is there ordinary income/profit or instead (some sort of) "capital" treatment? (There has been substantial case law here.) For the buyer/payee, is there ITA section 9/paragraph 18(1)(a) immediate deductibility or instead (some sort of) capital expenditure treatment?

- And there has been not insubstantial case law in this area
- (And as discussed below – in this intercompany cross-border context) –

(2) Sale/Purchase of Such Property

[To come: the cases to be considered:- *BP Canada Energy Resources Co. v. Canada*, [2002] T.C.J. No. 545 (T.C.C.); *Cafik v. M.N.R.*, 76 D.T.C. 1141 (Tax R.B.); *Canadian Industries Ltd. v. The Queen*, 80 D.T.C. 6163 (F.C.A.); *Consumers Software Inc. v. The Queen*, 95 D.T.C. 518 (T.C.C.); *Gingras v. M.N.R.*, 63 D.T.C. 1142 (Exch. Ct.); *Mr. R. v. M.N.R.*, 50 D.T.C. 398 (Tax A.B.); *No. 442 v. M.N.R.*, 57 D.T.C. 435 (Tax A.B.); *Stepanoff v. Canada*, [2006] T.C.J. No. 44 (T.C.C.), *Affd.*, [2007] F.C.J. No. 181 (F.C.A.)] (It will be seen that in principle dispositions not involving contingent sale price would generally be treated by a court in the manner that applies to dispositions of any property disposed of.)

- Seller
- Buyer

(3) Cancellation of Right/Licences

- Licensor
- Licensee

(4) Elsewhere

F. OTHER?

SECTION IV - TAX LAW – CROSS-BORDER – ARM’S LENGTH LICENCES²⁸

**A. CROSS-BORDER TRANSACTION-INBOUND PROVISION OF THINGS OR SERVICES AND
OUTBOUND PAYMENTS**

(1) Two Regimes

There are two regimes to consider when there is an outbound royalty (or certain other) payment to a third (arm’s length) party.

- Part XIII applies unless the transaction is part of a carrying on of business in Canada through a permanent establishment as defined in Part IV of the Income Tax Regulations. See ITA section ■ and Reg. section 805(■)
- Part I should not apply where Part XIII – as above – applies. (To elaborate on the following.)
 - But no clear rule on point (?)
 - There is favourable CRA views on point.
 - Discussion of untested issues.

(2) Departure from Commercial Law?

Does tax law here depart from or augment the commercial law and or domestic tax law notions of royalty?

²⁸ Considerations where e-commerce is involved is deferred until Section VI.

(a) Where Part I applies

- There generally is no departure. In part this stems from the fact, discussed above, that the word “royalty” is not used in Part I in respect of either domestic or on direct outbound transactions by Canadians or inbound transactions by non-residents.

(b) Where Part XIII applies? – The relevant definitions

There is no separate definition, *per se*.²⁹ The main rule (paragraph 212(1)(d)) employs the terms “royalty” and “rent” without defining them. The case law, (generally not specifically working off commercial law notions, but rather from what courts gleaned from other tax law decisions) has made clear that a royalty or a rent entails, in each case, three distinct factors.

In the case of “rent” (with most courts citing a definition by Mr. Justice Addy of the Federal Court Trial Division in *Vauban, supra*) the three elements are (1) there is property that is

²⁹ Duncan (Appendix 2) at page 416, has an interesting quote respecting the original meaning of “royalty”. Duncan traces the development of the notion of royalty arising strangely in the context of sale of mineral property for consideration that, *inter alia*, included a percentage of profit made by the buyer. Some cases said that this was ordinary income, a “royalty”. But then, there was the 1933 Judicial Committee of the Privy Council decision in *Spooner* (note ●), which held that it was capital and as noted elsewhere, this led to the enactment of paragraph 3(1)(f), replaced later by subsection 6(1) and now by paragraph 12(1)(g). And as noted, the original version used the word “royalty” in it, whereas the other two have not. There has been much written on royalties and related matters including emerging E-commerce in the cross-border arena many of those up to 1999 are cited in various footnotes in Duncan’s 1999 article (Appendix #2) and particularly at Note ● and, as well, in Jinyan Li’s book (Note ●) – for example, see Footnote 101, as well as her separate work, Jinyan Li, “Re-thinking Canada’s Source Rules In The Age Of Electronic Commerce: Part 1”, (1999) Vol. 47, No. 5, *Canadian Tax Journal*, 1077-1025. See also Pierre Gonthier, “Les déclinaisons de la notion de redevance selon l’impôt de la partie XIII: Redevance et concept élargi de redevance”, *Canadian Tax Journal*, 2003, Volume 51, No. 5, p. 1825 and Pierre Gonthier, “Les déclinaisons de la notion de redevance selon l’impôt de la partie XIII: Redevance et concept élargi de redevance”, *Canadian Tax Journal*, 2003, Volume 51, No. 6, p. 2119. In general, for purposes of this lecture, I have adopted the reasoning, views and conclusions of Duncan respecting the ambit and meaning of “royalty”, as that word is used in the introductory portion of paragraph 212(1)(d) which are as follows. First, the word relates to a situation where there is a use of something conveyed and not an alienation. Second, royalty is determined as a function of, and dependent upon the use made of the property by the licensee. Third, the object of the use is “property”. Note that there has been no substantial statutory change or case law developments since Duncan’s paper in 1999.

delivered by the payee to the payor, (2) the payor is entitled to use the property for a fixed period of time and then return it and, (3) the amount paid for that use is fixed (regardless of the intervals of payment).

In the case of royalties (as reflected by the courts in cases such as *Farmparts* and *Saint John*), the three elements are a combination of (i) the first two elements giving rise to “rent” and (ii) as to the third, rather than fixed payments for the use, payments which comprise some portion of the gross or net income or profits derived by the payor from using the property or payments depending upon some other measure production or productivity realized by the payor from using the property. (For example, in *Grand Toy*, this factor was described as follows:- “[A] a element of contingency in the payment for the use of property is therefore the essence of a royalty payment.”³⁰

Of course, there had been massive confusion arising out of a chain of Canadian and U.K. decisions in the earlier part of the 20th Century (closely (and probably, painfully) parsed by Duncan in (Appendix 2) culminating with the 1933 decision of the Privy Council in *Spooner*, which properly, in this observer’s view, decided the notion of “royalty” should not be considered to include a situation where there has been a total sale or alienation of property, but where the price to be paid or being paid in respect thereof is not fixed but, rather, has the same element of dependency or contingency associated with the payment of a royalty as discussed in the

³⁰ *Grand Toy*... at page ..., as identified by Jinyan Li in “International Taxation in the Age of Electronic Commerce: A Comparative Study”, *Canadian Tax Foundation*, 2003 at page 145.

preceding paragraph. The *Spooner* case, of course, as we have already seen lead to countering legislation which today comprises paragraph 12(1)(g) of the *Act*.³¹

- But, as discussed below – extended scope of taxation

(3) How is (foreign) recipient treated in Canada? – Part I

(a) Domestic – Part I

Per A(1)(a) – this is situation where NR receives royalties in course of carrying on a business in Canada through a permanent establishment within the meaning of either Part IV or XXVI of the ITR.

- Carrying on business? (versus income from property)
 - No specific rules
 - No case law on point
 - In a lending context, see *Placements Serco* (cite,) an assessing initiative by CRA motivated by inapplicability of Part XIII, because the target borrowers were based outside Canada (in the US).

³¹ It must be observed, however, that the clarity of this situation may not be complete given the succeeding decision of the Supreme Court in *Wain-Town*. In this respect, Jinyan. Li (*supra*) wrote at page 145:- “Thus payment may be characterized as royalty even when the form of the transaction is a “sale” or “service”.” (The reference to “service”, does differ from views expressed elsewhere and see, for example, *Hasbro*, which concluded that payments for service no matter how calculated do not come within the notion of royalty in the introductory portion of paragraph 212 (1)(d). Ms. Li points to the decision in *Gingras* 63 DTC 1142 (Exchequer Court), as support for the first proposition that involved the sale of a copyrighted sales manual for a fixed price, but where the payments were based on percentage of product sold. If the latter factor only affected the timing of payments not the ultimate obligation to pay the full fixed amount

- Other analogous situation?
- CRA?
- Permanent Establishment?
- Usual considerations

(b) Treaty – Part I

- Treaty Protection: see below
- [Question of difference between permanent establishment definition in relevant treaty and in ITA]

(c) Provincial?

(4) How is (foreign) recipient treated in Canada? – Part XIII

(a) Domestic – Part XIII

[This Part can apply where there is not both carrying on business in Canada and doing so through an ITA permanent establishment.]

(i) Basic (ITA paragraph 212(1)(d))

Paragraph 212(1)(d) in all of its dimensions [see Appendix • for the entire provision] could be seen (in light of the somewhat convoluted and complex cases that have been decided thereunder, as well as the somewhat controversial manner in which its statutory content has evolved and

then quite apart from the question of terminology that should not fall under paragraph 12(1)(g), a point

been enacted – for details see Duncan’s 1999 article, Appendix 2) to be a extremely slippery road to hoe. However, a metaphor comes to mind that may provide a workable approach to working through this provision and **that is to view it as a pyramid.**

Like all pyramids it starts off narrowly at the top – which here is the basic rule in the paragraph without regard to its subparagraphs – and then broadens as one descends towards the bottom – which, here, are the various subparagraphs. The key to the pyramid is that the narrow top is a narrow base of taxation and the broader lower parts are a broader base of taxation with, ironically, the narrow top comprising (or, more accurately, requiring) more elements relevant to analyzing the applicable tax rule and the broader lower portions comprising (or, more accurately, requiring) a lesser number of elements relevant to the applicable tax rule.

In particular, at the top of the pyramid, the paragraph imposes a 25% tax on, generally, payments made by a Canadian or deemed Canadian resident of rent or royalty to a non-resident (that rule also applies to so-called “similar payment” – instances of which I do not think I have yet to find). As discussed in section • above, in order for a payment to meet the case-made law definition of a rent three distinct characteristics or elements must be extant (a property, a giving of the property to be used and then the return of the property and a fixed payment or payments for the use during that duration). And to meet the case-made law definition of royalty three distinct characteristics or elements also must be extant (a property, a giving of the property to the used and then the return of the property and a contingent or dependent form or type of payment for the use of the property).

fully discussed by Duncan Osborne in his 1999 work in criticizing the decision in *Wain-Town, supra*.

As we will see, the pyramid broadens as we descend to the subparagraphs by reason of the removal of one or more of these characteristics or elements in order that the same tax of 25% apply. It may also be noted, that one could also say that the narrow top may not only be characterized by the two, three element sets of factors, just noted, but, as well, by the notion that a payment cannot be a rent or royalty where it relates to or is in respect of a transaction that either sees a transfer of all rights to the relevant property by the payee to the payor or as was raised in the Saint John Shipbuilding case a transfer of rights of use respecting property without the need that the property ever be returned, that is, rights of use in perpetuity. Overall, therefore, one may view the preamble or basic language of paragraph 212(1)(d) having the narrowest base of applicability (by reason of the requirements to characterize a payment as a rent or royalty) in relation to or in comparison to the balance of the provision (that is, the subparagraphs) that follow.

- 25% tax on gross³² amount of “royalty”
- Cash basis, not accrual³³
- Requires Canadian resident payor
 - Actual resident
 - Deemed resident for Part XIII

- ITA subsection 212(13)

³² *Burland*

- ITA subsection 212(13.1)

- ITA subsection 212(13.2)

- ITA subsection 212(13.3)

- Bill C-10 proposed addition, related to proposed section 66.4, paragraph 212(13)(g)

- US (and other foreign) counterparts (including “cascading” theories)

(ii) ITA subparagraph 212(1)(d)(i)

a) The Statute and Overview

The definition is:

“(d) Rents, royalties, etc. – rent, royalty or similar payment, including, but not so as to restrict the generality of the foregoing, any payment

(i) for the use of or for the right to use in Canada any property, invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process or other thing whatever,”

Here we have **the first widening or broadening of the pyramid**, a rule which has been the subject of much case law (particularly, the case of *Saint John Shipbuilding*³⁴ - This rule broadens the pyramid by apparently dropping one of the three requirements for a payment to be a rent or royalty.) In particular, **there is no requirement that the property given for use be**

³³ Applies when a Canadian “pays or credits”. (For a discussion, see, section ●)

returned. It is sufficient, according to, at least, *Farmparts* and *Hasbro*, (and strongly suggested, but not decided in *Saint John*), that there be only two of the requirements of a rent or royalty, namely, that property be given for use, but in the context of a transaction where there isn't a full sale of or alienation (see next section) of the property to the payor and that there be a payment of "any kind" (whether fixed or contingent) for that use. There is no requirement that the condition of a rental that the property given in use be returned be part of the arrangement.

But, strangely, the Federal Court of Appeal in August 1980 in the case of *Saint John Shipbuilding*, discussed below, declined to apply this formulation of the rule, although it strongly suggested it and instead decided the matter under the 1942 Canada-U.S. Treaty, notwithstanding that six months earlier, in February 1980, the same court (but a different panel – in part?, or in total?) had clearly decided, the case of *Farmparts*, that the subparagraph could apply to an arrangement that saw a fixed payment for the use of property in circumstances where the arrangement did not amount to a rent or royalty arrangement. There is a bit of uncertainty, actually, respecting this finding in *Farmparts* and the decision in *Farmparts* in that there is a bit of a disconnect between the formulation of the principle and the facts of the case, where arguably all of the elements of rent, in fact, did arise. See discussion further below.³⁵

It should be acknowledged that this paragraph does, in one sense, narrow the pyramid by requiring that the property be used in Canada in order for the tax to apply. The basic rule of the

³⁴ We will see below that *Saint John's* is relevant to this lecture in three distinct contexts – directly under this subparagraph as indirectly relevant in discussing the exemption under subparagraph (vi) and as a segue to our discussion of royalties in the e-commerce-internet context.

³⁵ There is also disagreement over the proper ambit of subparagraph (i). See *Duncan* (Appendix 2), at page 440 to 443.

paragraph has no such limitation, although there is a carve-out in one of the subparagraph ((ix) for “...the rental payment for use of the right to use outside Canada any corporal property”).³⁶

b) Threshold Context³⁷

It may be useful at this juncture before considering subparagraph (i) in further detail, to overview the overall relationship between the manner in which Canadian companies may access inputs from foreign persons in carrying on their businesses and the various subparagraphs in the provision. A Canadian business enterprise may make payments to non-residents in consideration of receiving (for use in its business) (1) ownership interests in whatever is conveyed or (2) the right to use whatever is conveyed or (3) a service from a non-resident (either performed in Canada or abroad). The price or consideration to be paid may be totally fixed (non-contingent) and specific (e.g. a single, lump sum amount or several fixed payments), or may in whole or in part be contingent (dependent) upon use.

If whatever is conveyed is recognized as property (i.e., without either not a service or not a nothing—see the case of *Quality Check'd* (cite) and its conflict with the case of *Western* (cite)), and the other conditions of “royalty”, as discussed above, are met, it will be subject to paragraph 212(1)(d). Here, we deal with all other cases where the next question is whether the arrangement and the payment seem to come squarely within the specific language of subparagraphs 212(1)(d)(i)-(v) and there is no case law which suggests a contrary point of view. Let’s examine the statutory language (see Appendix ●).

³⁶ It might also be noted that unlike subparagraph (i), but like the preamble to this provision, subparagraph (ii) respecting so-called “know how payments” discussed in the next section, also is not restricted to use in Canada.

At first blush, the language in subparagraph (i) seems reasonably clear and specific and easy to apply—except perhaps for the three troublesome words at the end of - “...or other thing whatever”. Isn’t that a prescription for mass confusion because would that include “information...” (per subparagraph (ii)) and thus neutering, subject to the point made below, that subparagraph (ii)?

When “information” is provided, is there an alienation of it or the mere granting of a use? If the latter, then there is no role for (ii).

And is there any reason why one could not distinguish (1) giving something to someone (a book, manual...) and (2) performing a service for that person? [But see Duncan’s footnote 60 (Appendix 2) and the question raised.]

Unhappily, the case law shows much uncertainty, although that in part is because of the content of the rules before amendment before 1968.

Subparagraphs (ii) and (iii) were added in 1968-1969 as a result of conflicts between the decisions in *Western* (1969) and *Quality Check’d* [1967]. For discussion, see Duncan (Appendix 2) at page 432. (See also, *Rolls Royce* in 1962, *Evans* in 1953, *Technical Tape* in 1964 and the cases specifically discussed below.)

c) A Threshold Issue – “use” versus “alienation or sale”

Clearly, a pivotal factor in considering whether a payment is a rent or royalty or one governed by subparagraph (i), is a question of whether the underlying transaction involved a “alienation” or a

³⁷ Further discussion of context is set out in below in analyzing the decision in *Hasbro*.

“sale” as opposed to one which conveys lesser rights and, in particular, rights of “use” only. And this can be a slippery question if not addressed from the correct perspective or standpoint in that the answer may differ as between whether one is looking at the payee or conveyor of the rights or, instead, the payor or recipient of the rights. This is because it could be argued by reference, for example, to the decision in *Saint John Shipbuilding* which involved a U.S. company providing access to a Canadian to use some sort of computer programme to build ships in exchange for a lump-sum payment and with a Canadian apparently being permitted to keep and use the programme in perpetuity, that is, not having an application to return it. The point is that the Federal Court of Appeal found that the transaction could arguably be subject to subparagraph (i) as involving a “use” only because the prohibition against any disposal or alienation by the Canadian of the programme to another party meant in the view of the FCA that the arrangement did not entail a “alienation”. The court made clear but for that limitation they would have considered that there had been an alienation and that, therefore, the transaction could not come within either the definition of rent nor the provisions of subparagraph (i).³⁸

The interesting point here is that regardless of how that would have been viewed in terms of alienation from the standpoint of the payor (and, as noted, it would have been viewed as an alienation from the standpoint of the payor for purposes of the provision) the transaction arguably in no way say the payee alienating anything, because it continued to own all of the property it owned before in respect of the computer programme and from its standpoint had merely given another party a copy of it for their use without diminishing in any way the property

³⁸ CRA has (gratuitously in my view) conceded (in IT ●) that, in principle, Part XIII does not apply where, *inter alia*, “use” has been delivered in the context of an alienation and notwithstanding some odd caselaw to the contract, but in a totally different context...

that it had started with. Therefore, in this respect, it would appear that the notion of whether there is a sale or alienation for purposes of Part XIII and as would, as just indicated, render either the preamble to paragraph 212(1)(d) or, subparagraph (i) thereof, inapplicable, is to be viewed from the standpoint of the Canadian payor in terms of what that person has received and not from the standpoint of the non-resident in terms of what they had or had not given or disposed of in relation to the rights and property that they had before the transaction with the Canadian.³⁹

d) Second Threshold Issue – “bundled” transactions

Issues have arisen in applying Part XIII (and separately in dealing with inter-company transfer pricing matters, dealt with in Section V - below), where parties enter into a contract that sees more than one type of thing delivered (whether a property, a service or something which exists but is neither of the latter and the amount paid by the recipient is not allocated by the parties as between its several components, Such a situation is often referred to as entailing a “bundled” transaction. As dealt with further below, taxpayers have benefited from such an arrangement in circumstances where the provider was a non-resident, some part of the transaction would have been subject to Part XIII tax but the government in an assessing initiative brought before the

³⁹ For authorities on and discussions of this pivotal point, see Duncan (Appendix 2) footnote 40 and the British cases of *British Salmon* ● and *Nethersole*. The first case, a 1938 U.K. decision found that an “exclusive licence” over a 10-year period was tantamount to a sale—consider this further and correlate to *Saint John Shipbuilding* which involved a non-exclusive licence. In the *Nethersole* case, as well as the *Davy Ashmore* case (India) at footnote 40, a differentiation rule (which was not adopted in *Saint John*) is of interest—that is differentiating between an alienation and a use. At page 429, Duncan refers to four factors cited in the *Rustroof* case as distinguishing between the two—quote page 429/430. In *Saint John*, the Court said there could not be an alienation if there was no right to re-sale. Can we reconcile *Saint John* on this with the cases cited above? Second, if you have a use, maybe it is a “royalty” or maybe it is simply on income account. Royalty would require that the payment is dependent upon the use, whereas where it’s a lump sum, it may simply be on income account.

Court made no effort to allocate as between those elements that would be subject to Part XIII tax and those elements that would not. See below in *Farmparts* and *Brad-Lea*.⁴⁰

CRA in IT 303 in paragraph 25 takes the position that if part of the payment is subject to Part XIII, they will take the whole amount unless the taxpayer shows a portion should be carved out. The Courts in *Farmparts* and *Brad-Lea* rejected this position.⁴¹

e) Third Threshold Issue – The role of terminology in a contract

Does the use of the word “royalty” in a contract necessarily govern the determination? Obviously, it should not be determinative and that has been held to be the case in various court decisions. See Duncan’s discussion of this at page 439.

f) Fourth Threshold Issue – Nature or Ambit of “Property”

The issue of whether the object of a contract that may be subject to the basic provision is “property” or something else had arisen prior to an amendment to paragraph 212(1)(d) in 1968—that is at a time when that paragraph and its subparagraphs would not apply if something provided by a non-resident was not considered to be “property”. The issue was highlighted by a disagreement of the courts in two cases, *Western* and *Quality*, over whether know-how is property. The court in *Western* considered that it is, and therefore could be subject to the rules of

⁴⁰ In *Brad-Lea*, the Court rejected the government’s position because the Minister did not allocate the payments as between “royalty” and “services”. In so doing, it relied on *Saint John Shipbuilding* (why?) and *Farmparts*. The Court said that CRA had the obligation to make that allocation.

⁴¹ CRA has recently (and again in my view gratuitously) conceded or acknowledged this case-made law in context of its series of memos on transfer pricing – “Transfer Pricing Memoranda”. See TPM # ● in Appendix ●. OECD in its commentary on Article 12 (Appendix 33) distinguishes the matter in a

the provisions as they then were, while the court in *Quality* concluded the contrary. The issue was dissolved by the 1968 addition to the provision of subparagraphs (2) and (3), dealt with below, pursuant to which Part XIII can apply where a non-resident provides something which is not meet the test of being a property. See discussion further below.

Is each item in subparagraph (i) a property? [See recent case that said goodwill is not property.]

g) The Case Law:

i) *Saint John Shipbuilding*⁴²

This 28-year old case saw the FCA almost (but not quite) conclude⁴³ that the Part XIII 25% tax arose under ITA subparagraph 212(1)(d)(i) in the following circumstances. (The case was decided on treaty grounds.)

- The Canadian payor in *Saint John* had the right to use software conveyed by a non-resident in perpetuity and had no obligation to ever return it.
- But, the Canadian did not have the right to on-sell to another party the software it had been given. (**Note:** for purposes of an issue with CRA, I bought a piece of Microsoft software that contained a licence which permitted sale of the software disc contained in the package, but of course without the right to reproduce, etc. This would be the exact counterpart of a purchase of a published book. More on this below.)

straightforward fashion—that is, between information and services—the former to be governed by Article 12 and the latter by Articles 7, etc. See section • below.

⁴² *Saint John Shipbuilding & Dry Dock Co. Ltd. v. The Queen*, the Tax Review Board, 76 DTC 1283, 79 DTC 5297 (F.C.T.D.); 80 DTC 6272 (F.C.A.).

- The reported decision by the Federal Court of Appeal in *Saint John* referred to "...a contract under which COM/COD supplied to a Canadian computer service company for the respondent (it might alternatively have been for the respondent's own computer had it had one of the kind required) tapes containing technical data or material referred to as the Autokon-I System which, when combined with input data on a specific ship's hull produced technical data for use in the construction of the hull. ... The respondent was...bound by the contract to keep the information obtained by the use of the system confidential and to use it only for the respondent's purposes. The contract does not purport to evidence a sale of the tapes and manuals to the respondent. Instead, it purports to be a grant of a non-exclusive license to use the system.... There is in the contract no reference to the ownership of the tapes or manuals so-supplied nor is there any provision which gave COM/COD any right in any circumstances to require that they be returned."
- The decisions of the two lower courts and the Federal Court-Trial Division shed the following additional light on the facts. The agreement was termed "Autokon License Agreement" and the agreement granted a "non-exclusive license".

Consistent with the discussion in section (i), the single lump sum payment was found to not constitute a "royalty" (necessitating the provisions in subparagraph (i)). The key factor which almost rendered subparagraph (i) applicable is that the prohibition imposed on the Canadian payor against resale or reassignment or other conveyance of what it received ostensibly brought

⁴³ Unfortunately, CRA has acted as though they had concluded. More on this below.

the arrangement within the ambit of, and only the ambit of, a “use”. (But the elephant in the room is that it clearly was a “use” that went beyond the norm.) Had the Canadian payor been entitled to reconvey what it received, the transaction presumably, would have been seen as the exact comparable to a sell-buy of a book transaction, which conveys more than a mere use – namely a right to sell the acquired book. That grants both the right to use and the right to alienate the thing received. Such a transaction is not subject to subparagraph (i), as it is one which does not come within its terms.⁴⁴

The *FCA in Saint John* confirmed the latter. (See Appendix 26.)

CRA acknowledges the latter delineation in •, where it says: [TO COME]

- Miscellaneous Points on Saint John and its Three Judgments⁴⁵

CRA’s IT 303 (see Appendix 22) which takes the position almost adopted in *Saint John* was issued four years before the Federal Court of Appeal decision in *Saint John*. CRA had continued to following its thinking in IT 303 as though the Court had made that decision.

Given that the F.C.A. in *Saint John* left the matter unresolved , what is the proper interpretation of sub. 212(1)(d)(i)?

See the suggestion by Duncan Osborne some ten years ago (Appendix 2) that subparagraph (i) be read as *not standing independent of the opening words of paragraph (d)*—so that a covered arrangement is one which inherently entails a “rent , royalty or similar payment”—and that sub.

⁴⁴ See • .

⁴⁵ See Appendix 26.

(i) be seen as...“a legislative clarification of the various types payment that may be a royalty payment that attracts withholding tax”.⁴⁶

The Tax Review Board found that the payment in *Saint John* was not a “rent” because the was no “use for a certain time” (as raised by the Exchequer Court in *United Geophysical*, 61 DTC 1099). It also wasn’t royalties because (relying on definitional analysis by Addy, FCTD in *Vaubhan* (75 DTC 5372)) the payments were not determined by reference to “degree of “use” (that makes sense) or to “duration of the use.” (that is difficult to assess).

Then the analysis become murky but emerges with a finding that the Canadian may have acquired ownership of property and was of “an enduring nature and not of a temporary or of a periodic nature. And the payment wasn’t taxable.

The FCTD says the Canadian neither bought anything (because it nt have right to alienate) nor paid rent or royalty. (Same reasoning there as TRB). The court also says that it is IRRELEVANT whether the payments constitute capital or non capital outlays to the Canadian—thus rejecting TRB.

⁴⁶ Note that because *Saint John* lacked a return of the property, it could not constitute a straight rental under para. 212(1)(d). But, is there potential malleability of the word “use” in sub (i)—and the thesis that, as used in that provision, it should be viewed in THREE not two different ways—TWO which are not to be governed by sub. (i)? First, a payer obtains, *inter alia*, a “ use” when there is a total “alienation” transaction. But that of course is not a “use” which would trigger sub. (i). Second where a person gets a “use” of property and then has to return the property and pays one or more fixed amounts, that—if for some reason not simply a rental—would reasonably be governed by sub. (i). And if one fact in *Saint John* had been different—rather than being entitled to keep the software in perpetuity, it had to be returned, say at the end of 50 years—there presumably would have been no difficulty. In bringing it within the later. Third, now we come to *Saint John*, where one gets to keep and use something in perpetuity. That is a far different “use” arrangement than the second and much closer to the first. And if that were given statutory recognition, the issue over sub. (i) should abate—and it’s probably an issue that is arising everyday in e-commerce, but is on nobody’s radar screen. Or, perhaps all it really requires, in light of the Supreme Court in the GAAR cases in October, 2005, is a contextual reading by a court?

Then the FCTD takes an interesting tactic re sub (i)—it skirts it by saying that the object of the K (technical info.) is specifically dealt with in sub. (ii), but that rule doesn't apply because there was no contingency AND having so found it wouldn't be fair (“justifiable_”) ..’ to attempt to classify under another subpara. by virtue of which it might be taxable”. (That’s actually quite interesting—but the FCA rejected that thesis.)

The FCA also rejects a rental or royalty analysis—for same reasons, as the TRB .

And, but for the treaty – that is had the FCA been required to decide the case on the basis of the *Act* - it seems quite clear that the FCA was heading for a textual-based finding that sub. (i) applied.

It will be observed that the net cast by sub-paragraph 106(1)(d)(i) is very broad. It includes not only “rent, royalty or a similar payment” but “any payment” for the use of or for the right to use in Canada” any “property” (a word which is defined in the broadest of terms in paragraph 139(1) (*ag*) (now a part of subsection 248(1)) or any of the items enumerated in the wording that follows it, or “other thing whatever”. This very broad wording came into effect in 1968. Prior to that the wording had been much narrower. *Western Electric Co. v. M.N.R.* was decided on it.

[...]

Assuming that the wording of subparagraph (1)(d)(i) of sections 106 and 212 is to have its full scope and is not to be restricted because of the presence of the subparagraphs which follow it, I am not satisfied that the provision is not broad enough to include the payments in question. It is not easy for a payment of the kind described to escape the definition of “any payment...for the use of or for the right to use in Canada any property...or other thing whatever”. (*The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd.*, pg. 6274)

But, to me, the *burning question* is why the FCA declined to pronounce on (find with respect to) subpara. (i)—in light of the clear statement by the FCA six months earlier in *Farmparts* (discussed next) that subpara. (i) is not constrained by the preamble to the paragraph?

ii) *Farmparts*⁴⁷

This decision of FCA is similar to *Grand Toy* (which came 8 years later) in that it involves payments that at least in part are for rights to be a distributor in Canada and is dissimilar in part by reference to nature of the payments. And it is similar to *Brad-Lea* for the way in which the “bundled” aspect of the arrangement defeated the Crown.

Here, under two agreements with a U.S. company (“Wonder International”) (“Company”), the Canadian (*Farmparts*) received ((1) certain use of the company’s trade name and logos (that looks like straight rent or royalty) (2) the right to use the concept or technique of merchandising replacement automobile muffler systems using a pipe bending machine developed by the company (sounds like things desc in either of the first two) and (3) distributorship rights – i.e. the EXCLUSIVE right to purchase and re-sell the pipe-bending machines within a defined territory to sub-distributors.⁴⁸

The lower court - FCTD- 79DTC 5193 - found that only payment for the use of the trademark “was on income account” (what does that mean--???) and subject to paragraph 212(i)(d). But because the Crown failed to allocate, no Part XIII tax applied.

There were total tax payments of \$115,000 made by *Farmparts*—and in an accompanying case, \$75,000. (The second case is exactly same except payments were \$75,000).

Farmpart’s customers are referred to as subdistributors (not as franchisees).

⁴⁷ Cite both FCTD and FCA.

Farmparts devised on its own package for sale to: subDs which “package” included one machine, an “ opening advertising programme “ (which F had made up by its ad agency) and the U.S. company’s “Wonder” decals and logo and a sign. At page 6159 the FCA writes-- “Of all of the parts of this ‘package’, only the exhaust pipe bending machine came from Wonder International”.

The FCTD noted that without specific authority granted by Company, but with its tacit approval, Farmparts granted the subD the right to “use the trade mark ‘Wonder Muffler’ and logos of Wonder International. However under the contract, upon termination between the Company and Farmparts the latter was to cease using them.

The FCTD (according to the FCA) found that sub (i) applied only to the right to use trade name and logo (and tacit right to on-grant) BECAUSE that was on “income account”. The rest was, according to the FCTD, “on capital account”. The FCA repeats the relevance of the latter.

But there was no way --on evidence- to allocate and the onus to do that was on Minister--- therefore the assessment falls--according to lower court.

The FCA starts with Crown’s view that the language of sub (i) picks up a payment of any kind for anything referred to in that and following subparas...“Whether or not it falls within the category of rent, royalty or a similar payment”. Pg 6160. In support the Crown pointed to a legislative change in 68 from “any such payment” to “any payment”.

⁴⁸ This seems comparable to a franchise operation where the Canadian was the head franchisee who could then appoint sub-franchisees. Didn’t Canadian have to have right to do latter and train subs and provide to them everything (all info etc.) it received?. See further below respecting franchises.

FCA says that is “well founded”. Those are a “ clear indication that Parliament intended that the payments described in subpara (i) to (v) be subject to the charge of the section whether or not those can be said to be ejusdem generis with “rent, royalty or a similar payment’ “. [at para. •]

Then FCA asks whether the payments come within the “four corners of section 212(1)(d)(i)”.

FCA says there was a ‘use’ of the tradename. And that the merchandising plan was either a plan or process or property within sub (i) and there was a use. But the exclusive right to buy and sell ((i.e. be an exclusive distributor) is not covered because it would only be covered if it were a right to use the machine --which it is not. And given the latter finding, the fact that the Crown did not allocate and the decisions in *Pillsbury* and *Conway* related to the latter point, the FCA dismissed the Crown’s appeal.⁴⁹

The FCA also rejected the alternative that the payments were rents or royalties. While its clear that they weren’t royalties, given that Ks were for a fixed period (25 years plus an option for another 15) why couldn’t they be a rent (contrary to St J where there was no time limit)?

iii) *Grand Toy*

As discussed above, the FCA expressed the clear view, in February 1980 in *Farmparts*, and strongly suggested, in August 1980 in *Saint John Shipbuilding*- (but, surprisingly, without

⁴⁹ Then FCA focuses on the Crown’s assumption that(b). Company granted rights including use of machines , (c) the payment was for rights to use Company’s prop and (c) the payment was a FRANCHISE fee..... On the question of “franchise fees”...

reference to *Farmparts*), that subparagraph (i) can pick up a payment which is not characterized by the attributes or features of a rent or royalty or similar payment.⁵⁰

As noted above, in the first (*Farmparts*), the FCA would have clearly found the portion of the fixed payments for the right to use the trade marks and the technical information and data [although non-royalty like (no dependant - upon factor) and arguably non-rent like (there was a term but the court seems to ignore it after identifying it)] would be taxable under Part XIII by reason of sub (i) and that liability did not arise only because the Crown failed to show what part of the overall payments related to those two items. In the second (*Saint John*), the FCA strongly signalled that it would have found that the payment for the computer programs, [although non-royalty -like not dependant) and non-rent -like (no fixed term)] would be taxable under Part XIII by reason of sub (i), and that liability did not arise only because of the 1942 Canada-U.S. Treaty.

In the cases leading up to the 1968 amendments of paragraph 212(1)(d), the same sub (i) issue did not arise *per se*. (Check accuracy.) Rather the focus was on whether know how was property for sub (i) -with a conflict between *Tech Tape* and *Western* on the one hand and *Quality Checkd* on the other, leading to the 1968 additions---[(to paragraph 212(1)(d)] as a means of capturing contingent payments whether or not the object thereof is property or services or "nothings"⁵¹--- And those cases did not involve fixed payments [check] so that the subject issues did not arise.⁵²

⁵⁰ It was also noted that the lower courts in both cases had, at least, implied the latter requirement as was firmly contended for by Duncan Osborne (Appendix 2).

⁵¹ Sub (ii) was added to deal with ROYALTY-like ("dependant") payments for know how (information, etc.) and sub (iii) to deal with such payments for services (particularly in light of apparent court conclusions that the definition of royalty ---tax or non tax-- sees a requirement that there be provision of the use of property

This brings us to the third (and last) case respecting the basic issue ---sub (i) and non-contingent payments-- the 1991 decision in *Grand Toy*. (Check for others.)

This case involved payments that (like in *Farmparts*) could be viewed as fixed amounts paid by a Canadian to a non resident for the right to be the exclusive Canadian distributor of products made by the non resident. That would be in the sense that although the basic deal was that, as part of the overall price, paid for each unit of product sold by NR to the Canadian, there was to be an amount of 52 cents (identified, inaccurately and inappropriately in the contract as a "Buying Commission and Royalty Amount"), there was to be paid a minimum of \$400,000 of such 52 cent amounts, even if there were no product whatsoever purchased by the Canadian from the NR. If instead the Canadian purchased at least (roughly) 800,000 units, the 52 cent amounts could simply be viewed as part of the price charged by the NR to the Canadian for each unit of product (which is exactly how it was viewed by the customs people at CRA). Unlike *Farmparts* there was no provision of other things (i.e. -- trade marks, technical info as might trigger Part XIII).

CRA - undoubtedly driven by the taxpayers unfortunate terminology - asserted Part XIII tax, but that, logically, was rebuffed by the Tax Court.

The reasoning of the Tax Court involved the following key elements.

which is the object to the payment and that the provision of services cannot trigger the notion of royalty *per se*). For a full discussion, see Osborne – Appendix 2.

⁵² [To come. Brief notes respecting both these cases and other pre-1980 prominent 212(1)(d) cases.]

First the court relied upon the Supreme Court in *Wain-Town Gas and Oil* that the use of the word "royalty" in a contract does not necessarily mean it involves royalties. (See discussion above.)

Second, the court rejects the royalty characterization by relying on the requirement stipulated by Addy J in *Vauban* and the FCA in *Saint John* that royalty requires a payment which is a share or portion or percentage of the payer's gross sales revenue or net profit or is computed as an amount for each unit of something sold or leased by the payer and rent requires a payment determined by reference to a period of use.

Third, on sub (i) the payer was not given a right to use anything in Canada. (More specifically, the products bought weren't to be used but to be resold—although see related issue below for software distribution) Fourth—(and this is a little unfortunately imprecise), court concluded that the payments shouldn't be considered to be for the distributorship, but even if they were, "...this would not make them royalties. Rather they would be capital payments. In this respect two things. First the FCA, in *Farmparts* rejected the view of the lower court that an "income versus capital" characterization is relevant to interpreting any part of paragraph 212(1)(d). Second, this seems to ignore the specific finding of *Farmparts* that a payment for a distributorship is not a Part XIII payment. As well, even if "capital", there could be separately the issue of subpara. (v)—related to parag. 12(1)(g) discussed below ---sub V and 12() (1)(g).

[Finally, Duncan Osborne expresses some reservations respecting the analysis in *Grand Toy*.
(To come).]

iv) **Other Countries on *Saint John*?**

An informal canvass of several other countries (Appendix ■) indicates that most that do tax an outbound "royalty" payment would tax the payments which arose in *Saint John* in a similar

inbound-outbound transaction. In some cases that would arise by reason of a more expansive definition of “royalty” (in relation to outbound payments) and in others by reason of rules similar to subparagraph (i).

As discussed in more detail below, treaties may cut down the ambit of *Saint John* and subparagraph (i) – either by specifically excluding (under “Article 12”) royalties (defined perhaps in a way to exclude *Saint John*-type payments) respecting specified things (such as copyright software – as we see in the Canada-U.S. and Canada-Netherlands treaties) or by reason of Canada adopting aspects of the revised 2008 OECD Model Treaty commentaries.

Relevant to the latter is that in 2000, a mandate was given to an OECD “Technical Advisory Group” (TAG) to “monitor” the “existing treaty norms” respecting taxation of e-commerce business profits. This included matters concerning software transactions.

As discussed further in Section VI – respecting e-commerce - on February 1, 2001, an OECD TAG study on treaty characterization (as between Article 7 and Article 12) of e-commerce payments concluded with a report to Working Party No. 1 (“Tax Treaty Characterization Issues Arising From E-Commerce, A Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs, by the Technical Advisory Group (TAG) on Treaty Characterization of Electronic Commerce Payments, February 1, 2001). (See Appendix 82.) This report entailed recommendations for changes to the Commentary on Article 12.⁵³ Pertinent here was a proposed

⁵³ An October 2, 2001 draft then set out in draft commentary the TAG recommendations respecting Article 12. See the final commentary in Appendix 33. See, Nathan Boidman and Mark D. Brender, “Canadian Taxation of Inbound Electronic Commerce (Part 1), *e-commerce*, Tax Planning International, Vol. 2, No. 3, March 2000, page 3 and Part 2, vol. 2, No. 5, May 2000, page 4. See also, Jinyan Li, “Rethinking Canada’s Source Rules In The Age Of Electronic Commerce: Part II”, 1999, 47 *Canadian Tax Journal*, at p. 1411.

extension of paragraph 14 and new paragraphs 17.1-17.4, which would cut down the ambit of Part XIII. As a result, in 2001 Canada was in a “reserve” mode on that Article 12 commentary (paragraph 14) respecting computer software which conflicted with *Saint John*. But then in the June 18, 2002 Income Tax Technical Notes No. 23, CCRA stated that on March 28, 2002, the Department of Finance informed the OECD that Canada is removing the reservation - subject to the special cases in paragraph 14.3. This was reiterated in the next release Income Tax Technical Notes No. 25 - October 30, 2002.

[The Indian case of *Davy Ashmore* in 1991 seems to be the obverse of *Saint John*.]

h) Distributors and Saint John and the Ancillary Notion of Shrink Wrap

In light of CRA’s (indirect) view that *Saint John* would tax any conveyance of software which falls short of a full alienation (as in a “book” sale), it decided to inject some reality by adopting, in 1994, a “liberal” approach. In 1994 CRA ITD issued ITP-94-07 which treated, as a sale—not a *Saint John Shipbuilding* ITA subparagraph 212(1)(d)(i) payment,- a conveyance by a NR of “shrinkwrap” software not involving the signing of a license, for a single straight payment, even if the package contained a prohibition from assigning its contents. This was a partial retreat from Revenue Canada’s assessing initiatives of foreign software sellers on the basis that what they receive is not sale proceeds but rather payments for the right to use which (having regard to CRA’s view of *Saint John Shipbuilding* and subparagraph 212(1)(d)(i) of the *Act*) are subject to a 25% withholding tax (on the gross) subject to treaty reduction.

See, Pierre J. Bourgeois, “OECD Virtual Indecision”, *Canadian Tax Highlights* (July 25, 2000); and Pierre J. Bourgeois, “OECD Virtual Redraft”, in *Canadian Tax Highlights*, (October 24, 2000).”

Three things happened which substantially diminished this issue. First, in 1994 there was the above-noted International Tax Directorate of Revenue Canada, ITP-94-07.⁵⁴ Second, many software developers of widely distributed so-called shrinkwrap software no longer even seek to restrict the sale or alienation, the matter commercially probably being no different than selling a music album or CD or cassette or a book, where such sellers have never sought to prevent a buyer from reselling the single slug which has been purchased. In such case, subparagraph 212(1)(d)(i) of the Act, can have no application. Third, pursuant to a 1993 Budget treaty renegotiations between Canada and other countries, such as the United States, the Netherlands, France and others, now provide exemption from the Part XIII withholding tax where the payments are made for software even if only for the use of software and not a “sale” of the software.

Residually, however, liability to tax will arise (in the eyes of Revenue Canada) where the software is sold subject to restrictive non-assignment license, unless (in the view of Revenue Canada) in stipulated “shrink wrap” format (per ITP-94-07) or unless there is exemption under a recently renegotiated treaty. To be clear, this issue will arise whether or not such non-digitized software is sold through conventional means or through the internet. If the arrangement qualifies for “sale” [not ITA subparagraph 212(1)(d)(i)] characterization under the foregoing factors, then there is the separate question as to whether there is business being carried on in Canada and, if

⁵⁴ As noted, this developed a safe harbour for so-called “shrink wrap”, that is packaged standard software sold without the signing of a specific license notwithstanding that a license within the software package might prohibit reassignment of that single package (e.g. CD) which has been acquired. Under the safe harbour, such a transaction will not be treated as being subject to subparagraph 212(1)(d)(i) of the Act.

so, there is the further question of whether that business is carried on through a permanent establishment. This brings us to distributors.

A particularly thorny issue arising by reason of the decision in *Saint John* for U.S. developers of software sold to Canadian customers through related or independent Canadian distribution companies was eliminated (except perhaps for those U.S. entities operating through disregard or flow-thru limited liability companies) by the 1997 Fourth Protocol or 1995 Third Protocol to the Canada-U.S. Treaty. More on this in a moment. However, the issue continues for those foreign-based software developers marketing in Canada in this fashion, where either they are resident in a country that has no treaty with Canada, or has a treaty which does not feature the change made in 1995 or 1997 in the Canada-U.S. treaty.

Given the strong suggestion in *Saint John* that a conveyance by a non-resident of software to a Canadian without the attributes of a sale or alienation (e.g. where, as in *Saint John*, the Canadian may be granted use in perpetuity but not the right to dispose to a third party) for a lump sum payment is subject to tax under subparagraph (i)—and the conceptual confirmation of this by the prior decision in *Farmparts* (all of which has been discussed above), what is the analysis where there is a “middleman” – i.e. a “distributor” between the foreign maker of the software and the end Canadian purchaser-user, the arrangements are such that in the course of the “sale” by the foreign party to the distributor and the re-sale by the distributor to the Canadian end-user, there is effectuated through one means or another an undertaking by the Canadian end-user in favour of the foreign party to not resell or alienate? Is the Canadian distributor “using” the software within the meaning of subparagraph (i), or given that its only interest is in fact on selling it and not using it, that notion is not properly applicable so that the amount paid by the Canadian distributor to the foreign party do not come within subparagraph (i)?

CRA clearly takes the position that subparagraph (i) can apply. However, there are cogent arguments to the contrary.⁵⁵ One of those arguments for which there is no judicial support involves the exemptive provisions of subparagraph 212(1)(d)(vi) discussed below—namely that the distribution arrangement involves a constructive, if not actual, reproduction of the software so as to engage the exemption in that subparagraph for payments made for the right to reproduce property subject to copyright protection.

(iii) ITA subparagraph 212(1)(d)(ii)

This reads as follows: [To put in from Act] (Reproduced as part of Appendix 21.)

⁵⁵ The arguments and views on both sides of the question may find support or is expressed in, *inter alia*, the following:

JURISPRUDENCE

Apple Computer Inc. v. Mackintosh Computers Ltd. (1990), 71 DLR (4th) 95
Entré Computer Centers Inc. v. The Queen, 97 DTC 846 (TCC – no appeal filed)
Grand Toys Ltd. v. M.N.R., 90 DTC 1059 (TCC)
Qualico Developments Ltd. v. The Queen, 84 DTC 6119
The queen V. Farmparts Distributing Ltd., 80 DTC 6157 (FCA)
The Queen v. MCA Television Limited, 96 DTC 6411 (FCA)
The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd., 80 DTC 6272 (FCA)

DOCTRINE

Interpretation Bulletin IT-303 – *Know-how and similar payments to non-residents*
Revenue Canada Outline Views document no. 5-3485 dated July 28, 1987
Revenue Canada Outline Views document no. 9230057 dated October 9, 1992
Revenue Canada Outline Views document no. 9410765 dated November 16, 1994
Revenue Canada Outline Views document no. 9419825 dated August 17, 1995
Revenue Canada Outline Views document no. 9621950 dated February 13, 1997
Revenue Canada Outline Views document no. January 1991-244

PUBLICATION

MURRAY, Kenneth J., “Computer Software: Canadian and Cross-Border Issues”, *Report of Proceedings of Forty-Fifth Tax Conference 1993 Tax Conference* (Toronto: Canadian Tax Foundation, 1994) 27:1-41

This subparagraph also broadens the pyramid by dropping the requirement for a rent or royalty or that there be “property” conveyed. This answers to the issue in the pre-1968 caselaw.⁵⁶ This rule permits taxation of payments for know-how. According to Duncan Osborne (Appendix 2, page 431), it is anything which is “on paper”, or in electronic form used in carrying on a business other than those specifically protected, such as patents.⁵⁷

For the definitive court explanation of what is contemplated, see below in the next section, the review of case—*Hasbro*—where the question should never have arisen!

This rule imposes on such a Canadian outbound payment the same tax (25% on the gross) as would apply to a conventional outbound royalty or rental payment.

(iv) ITA subparagraph 212(1)(d)(iii)

As in the case of the first two subparagraphs, subparagraph (iii) broadens the pyramid by potentially imposing a tax where there clearly is no property being delivered to a Canadian payor and, therefore, cannot possibly meet the base definition of rent or royalty and, instead, involves the provision of services in consideration for fees which are subject to certain contingencies.

The legislative idea appears to be to impose a Part XIII tax on any transaction where the Canadian pays over some contingent portion of their revenue or profit to a non-resident in consideration for receiving something from that non-resident (whether it is the use of a property or whether it is the use of something that does not amount to property such as in subparagraph

⁵⁶ Is know-how property—yes, according to *Technical Tape* and *Western Electric*, but no according to *Quality Check'd*.

⁵⁷ For definitions of know-how, also see the *Rolls Royce* case, the OECD and IT 303 at para. 3. And then see the conflicting cases involving *Quality Check'd* at page 432.

(ii), or whether it is something that simply doesn't entail property because it comprises a service—which, obviously, cannot be returned to the service provider once received and consumed). Subparagraph (iii) reads as follows:

“...any payment (iii) for services of an industrial, commercial or scientific character performed by a non-resident person where the total amount payable as consideration for those services is dependent in whole or in part on

(A) the use to be made of, or the benefit to be derived from, those services,

(B) production or sales of goods or services, or

(C) profits,

but not including a payment made for services performed in connection with the sale of property or the negotiation of a contract...”

Clear, straightforward, not susceptible to controversy of interpretation? Having regard to the portion of the provision that proceeds, one would think the answer is affirmative and all would easily agree to as what type of actual transaction it would apply. But, not so, at least, in the eyes of CRA and the Tax Court of Canada, where regard is had to the convoluted journey one must take in working through this provision in the case of *Hasbro*. That case is a testament to the spectre of how reasonable tax policy can be the object of distortive thinking⁵⁸

To read *Hasbro* is to see ones future if the government does not follow the advice of those including TEI who have advocated that it scrap the 94, 94.1⁵⁹ and the section 68 component of the 56.4 proposals, or is to be reminded of the trials and tribulations visited upon the business

⁵⁸ Quite apart from the particular troublesome (and in this observer's unnecessary) court proceedings issue that arose in *Hasbro*, it is worth knowing that the court in that case clearly views *Farmparts* and *Saint John* as taking the position that a payment can be subject to tax under subparagraph (i), even though it does not have the characteristic of a rent or royalty. This is seen in paragraphs 16, 17 and 18 of the judgment which read as follows. [TO BE PUT IN]

and tax communities by the rules in, for example, section 55, 88(1), 95(6) and 247(2)(b), the latter dealt with below---namely the extremely frustrating dynamic of a good tax policy initiative run amok by overbroad legislation and the spectre of distortive interpretations by CRA.

Hasbro sees a situation (payments by a Canadian to a foreign sourcing agent for typical sourcing services respecting goods or products the Canadian wishes to purchase from foreign suppliers, which payments are computed in a typical way – namely a % of the cost to the Canadian of the goods sourced by the sourcing agent) which intuitively all would know was not to be the object of Canadian tax (under rules written for royalties paid to non residents) barely (as a result of the factors noted in the prior paragraph) escaping (pursuant to the decision of the Tax Court in that case)) that result (Canadian taxation).

Background. As noted at the outset of this section, Canadian companies may acquire inputs of many types, required for their businesses, from non residents. Some situations, in terms of Canadian tax effects for the NR, have been and are the object of relatively clear and logical tax policy and rules that implement such policy - clear, although.... (without regard to tax treaty) as to the non-resident's ultimate Canadian tax liability (or as to the absence of same) and of equal importance, as to any withholding tax obligations of the Canadian acquirer of the input (whether involving the delivery, by the NR, of services or of things - including corporeal and incorporeal, tangible and intangible) and in the latter case, whether the delivery involves mere use for a fixed term or more extended use - but calling short of delivering rights of ownership of ownership rights.

⁵⁹ See, *inter alia*, recommendations on this of the December 10, 2008 final report of the government's

For example, a Canadian may wish to buy and resell a product, designed, made and branded by a NR who simply delivers the product, and an accompanying invoice. In concept (if not in application) this presents No problem , in terms of tax results. Case law and/or section 253 will tell you whether the NR is carrying on business in Canada and if negative - no Canadian tax, and if positive - there may, depending upon a number of factors, be Canadian tax. And for the buyer, there is no withholding obligations -- or uncertainties in respect thereof.⁶⁰ And these results could well make sense.

In carrying on (in Canada, only) the latter simple business, the Canadian may require the temporary use of a particular piece of equipment or other thing and may lease it from a NR--- who has no other dealings in or through Canada - for a fixed period at a fixed rent. Here the tax rules would operate clearly. Para (d) would impose tax, to be withheld by Canadian party. And the result makes sense.

Or the Canadian purchases a single copy of a copyrighted book dealing with some area of its business from a NR raising the exact same tax rules as applicable to the above noted purchase of goods for resale.

Or the Canadian procures a service from an unaffiliated non-resident in consideration of a fixed fee. Whether the service is performed in or out of Canada both the substantive and compliance/withholding obligation tax results are clear---both ARISING in the first case and none in the second case.

Advisory Panel in reform of Canada's internal tax rules. [PUT IN FULL CITE]

⁶⁰ Note re inventory and TCP.

But where the Canadian requires access to and input from a NR in other areas the picture--tax policy and rules related thereto may (as we have already seen) become unclear, murky and difficult to identify and/or comply with--leading to disputes and litigation which, unfortunately, may not even serve to conclusively clarify the issue in question. That was seen in the *Saint John* case where the treaty solution saw left undecided whether sub (i) applies to a transaction having the particular features seen in that case--although the pronouncements of the courts in *Farmparta* (above) and *Hasbro* herein, below respecting the kernel issue (that sub (i) is need not be seen as constrained by the preamble) ostensibly provides that answer to *St John*. But that conclusion is not certain because (1) the FCA in *Saint John* came after the FCA in *Farmparts* but did not refer to it and (2) the Tax Court's view on the issue in *Hasbro* was based on *Saint John* and *Farmparts*.

Aside from the latter uncertainty respecting the ambit of sub (i) – arising out of the 68 amendments (query Finance explanatory notes at that time?) what was their intended ambit respecting services dealt with in new sub (iii) that they enacted and how did that rule lead to the litigation in *Hasbro*? What does the rule say? (See above) Why was it enacted? Is there a clear link between the first two factors? If yes, why was there any uncertainty respecting *Hasbro*. If there wasn't, was the *Hasbro* litigation inevitable or should that case's relevant transaction (given context and purpose) been so obviously outside the parameters of the provision that it should have never been raised as an issue by the Crown?

The rule was a added thought, or add-on, to the main response by the government to the question raised by the court's conflicting decisions in *Western Electric* (and *Technical Tape*) and in *Quality Check'd* as to whether contracts which saw NR make available to a Canadian access to special/secret business knowledge or information (collectively "know how") entailed a provision

of use of property as would trigger Part XIII tax (pursuant to the pre-existing provisions of section 106 - which became section 212 in the post 71 tax reform Act). Section 106 (1)(d)(ii), added in 1968, which became sub paragraph 212(1)(d)(ii) of the post 71 Act, resolved that point and made clear that, in specified circumstances (involving contingent payments) such "know how" would be taxable--if it wasn't otherwise picked up under other aspects of the rules and (as held by the FCA in *Farmparts*, overruling the lower court) that new rule--if not applicable on its face (because, for example, the payment involved is not contingent) - did not preclude the application of the more general rule of sub (i), if it fit.

That add-on or added thought was that if Canadian tax should apply where a NR licences a proprietary intangible in consideration for a royalty-type payment or provides the use of know how in consideration for a royalty type payment (per the 1968 add of sub (ii)) then if the form by which a NR provides to a Canadian input respecting business knowledge, information and experience is by way of providing or performing a service (which could, of course also see the accompanying and ancillary provision of the use of know how or of property or other things) and the payment in respect thereof is to be comprised of the same (royalty-type) features as would characterize a payment that constitutes a royalty for the preamble or a payment to be taxed by reason of new sub (ii), that should also be taxed under Part XIII. Fair enough. The concept is simple enough and really clear.

What words were used to effectuate this goal? See above.

On its face this language would seem, in general terms, to capture the policy objective. And on its face there is no reason to think that the policy objective had in mind or intended to tax the sourcing payments that were made in *Hasbro*. Nor, on its face, would a quick reading of the

actual language of subparagraph (iii) provide any suggestion or indication that that language could be read--literally or purely textually--to possibly apply to the sourcing arrangements in *Hasbro*.

But there are two elephants in the room. One is the "A" part of the dependency or contingency aspect of the rule. The second is the infinite capacity to see shadows that don't exist. In that context we see CRA taking this matter to court and only barely losing----when all logic (i.e. context and purpose) tell us the matter should never have been in court and, if in court, it shouldn't even have been close.

As to the exact sourcing arrangements in *Hasbro*---see Appendix 27. The key is that the payments were required to be made once and as soon as the service had been completely rendered without regard to whether *Hasbro* ever made a sale of the goods sourced or made a profit from any sales that did ensue---although it is true that the sourcing agent might have expended effort and never be paid if *Hasbro* had decided not to purchase goods pursuant to the agent's efforts.

BUT the scheme of the provision clearly contemplates a totally different relationship between the service and the payment in respect thereof---namely that FIRST the service is completely rendered and then one waits to see what revenue or profit the payer generates from having received that service in order to measure and determine whether there is a fee to be paid or whether some part of the fee is to be paid. So why was this decision so difficult for the Tax Court to make and why did it even come close to going the other way, and indeed why did it have to be decided on an exception (involving services related to a sale of goods) to the rule?

Was (is) the problem the drafting of the rule or, instead, the Tax Court's approach and appreciation of the rule or a bit (a combination) of both?

Let's review the key elements of the judgment.

But first a couple of side bars. First, as a matter of the facts and the issue, paragraphs 11 and 12 of the agreed statement of facts (paragraph 4 of the judgment) and paragraph 4 and 10 of an exhibit (paragraph 6 of the judgment) contain conflicting facts as to the relationship between the Canadian, the agent and the suppliers (manufacturers), suggesting in part that it was agency - as gave rise to the issue - and in other part that it was principal to principal (which logically would have seen all the payments made by Canadian constituting price paid for product, which would have eliminated any possible applicability of Part XIII). However, this does not appear to have been raised by the taxpayer or the Court.

Second, if the Crown was right, wouldn't that have made it redundant to have enacted, in 1994, the paragraph 95(2)(a.1) component of FAPI--for foreign related party sourcing activity? That was also not raised by the taxpayer or the Court.

The court starts off dismissing any claim that the payments were straight rent or royalty. Why was that necessary?

Reference is made to a favourite source of the courts on the meaning of royalty--*Vauban* and then to *Grand Toy* and the court then lends its own take on a definition, in paragraph 22,

“22. A royalty or similar payment is therefore one made for the use of property, rights or information whereby the payments for such use are contingent upon the extent or duration of use, profits or sales by the user.”

And then in paragraph 23, the court comes to the (unnecessary) conclusion that payments to the agent weren't royalties or similar payment.

And then --after a lengthy discussion of the ambit of object of sub ii, (which the court concludes is know how) including an interesting analysis of the 1968 legislative intent by reference to OECD (see paragraph 24 to 31), the court rightly and obviously rejects the (ridiculous) notion that agent was supplying sub ii information as opposed to merely providing a service (and in so doing the agent was (itself) utilizing its know how)---see paragraph 34.⁶¹

“34. More to the point, in my view, the information provided to the appellant by its purchasing agents concerning negotiations with manufacturers, price quotations, delivery schedules, shipment arrangements, etc. does not constitute know-how imparted to the appellant. This is specific information concerning the details of commercial transactions between parties situated in different countries, effected through an intermediary, nothing more. Moreover, while the agreement does say that HFE would provide "up-to-date market research and information..." and would "investigate ... activities in the Far East which relate to Hasbro Canada or which might provide additional business opportunities for Hasbro Canada ...", it is doubtful whether such information could ever be considered know-how. Finally, I must point out that the evidence presented at trial indicates that no such information was actually transferred to Hasbro. The May 12, 1995 letter from Hasbro to Mr. Daniel Anctil of Revenue Canada and the testimony given by Mr. Stark both make it clear that the purchasing agents provided services almost exclusively in the nature of arranging and supervising purchasing orders. If, indeed, the purchasing agents had a certain level of expertise and experience it would seem that they used their knowledge themselves in providing the various services to Hasbro. In my opinion, subparagraph 212(1)(d)(ii) simply has no application in the present case.”

The taxpayer argued that sub(iii) should be restricted to "technical services" or "...services analogous to intellectual property". But such limited scope is not apparent in the language and nor required by the tax policy objective. And that was the finding by the Judge.⁶² It could be

⁶¹ See fn 7 in Osborne (Appendix 2).

⁶² The judge concluded that after taking into account the following in favour of the taxpayer's position. See paragraphs 35-42 of the judgment (Appendix 27)]--bearing in mind how earlier in the piece the Judge

argued that this was nothing more than a textual interpretation where the court (as is generally the case) is reluctant to easily depart to a contextual or purposive interpretation).

It was also argued (rightly) that sub iii required "...payments computed in a manner substantially similar to royalty payments." But the analysis gets grounded in the actual language and the court accepts what would appear to be the untenable notion that the reference point for dependency could (arguably) be to the sales or profits of a person other than the payer. That cannot be right. Though this seems to be totally without merit, it is a possibility that the court not only sees BUT WHICH prevents the court from disposing of the case on the basis (which it finds in paragraph 43) that the payments by *Hasbro* clearly did not invoke clauses A, B or C in relation to its own affairs. This debate must be seen in the words of the court itself, as set out in paragraph 43 and paragraph 44 --which read as follows.

"43. However, it is less clear whether the payments from **Hasbro** to its purchasing agents satisfy any of the criteria enumerated in clauses 212(1)(d)(iii)(A) through (C). These clauses require that the total amount payable to the non-resident provider of the services be dependent to some extent on the "use to be made of or the benefit to be derived from, those services" on "production or sales of goods or services" or on "profits". One interpretation of that condition is that the use or benefit, production or sales or profits referred to in these clauses should only cover those of the payer and not those of any other party. If I adhere to this interpretation of clauses 212(1)(d)(iii)(A) through (C), then the appeals must succeed because the payments from Hasbro to its purchasing agents were not dependent in whole or in part on the use, benefit, production, sales or profits of Hasbro. However, one problem is that this interpretation requires that I effectively read the phrase "by the payer" into these clauses. In his arguments on the phrase "in connection with the sale of property", as found in the postamble of subparagraph 212(1)(d)(iii), counsel for the appellant referred to the rule of statutory interpretation which mitigates against reading in extra words or phrases where a reasonable interpretation could be had without them (See *Friesen v. R.* (1995), 95 D.T.C. 5551 (S.C.C.) at page 5556; R.

relied on OECD in defining the scope of sub (ii)--and query there the use of subsequent Commentary. But here, for sub iii, there was no OECD material that could serve as a reference point for what Finance Minister Benson had in mind in 1968.

v. Pongrantz (1982), 82 D.T.C. 6200 (Fed. C.A.) at page 6203). The same should also hold true here. However, I do not think it is necessary to reach a definite conclusion on that question because even if I assume that the terms of clauses 212(1)(d)(iii)(A) through (C) apply to third parties that would not change the final outcome of this case because of the exclusion in the postamble of subparagraph 212(1)(d)(iii). While I am of the opinion that the use, benefit, production, sales and profits referred to in clauses 212(1)(d)(iii)(A) through (C) were intended to refer primarily to those of the payer, I recognize that it is not an unreasonable interpretation that they can sometimes refer to the use, benefit, production, sales or profits of third parties. In the present case, the phrase "dependent ... on ... sales of goods" could thus, as argued by counsel for the respondent, include payments which are dependent on the sales of goods by third parties, like the sales by the manufacturers to Hasbro. Assuming this is so, it must be decided whether or not these payments are excluded by the postamble of subparagraph 212(1)(d)(iii)."

44. Counsel for the appellant submitted that the phrase "in connection with" as found in the postamble of subparagraph 212(1)(d)(iii) should be interpreted broadly and similar in scope to a phrase like "having to do with". According to a decision of the British Columbia Supreme Court referred to by the appellant, *Nanaimo Community Hotel Ltd. v. British Columbia (Board of Referees appointed under Excess Profits Tax Act, 1940)*, [1944] 4 D.L.R. 638 (B.C. S.C.) at page 639, "the words would include matters occurring prior to as well as subsequent to or consequent upon, so long as they are related to the principal thing". To the same effect one can also refer to *Hutchinson v. Berridge* (1922), 18 Alta. L.R. 121, 66 D.L.R. 753 (Alta. C.A.); *I.G.T.C. Ltd. v. Minister of National Revenue* (1982), 82 D.T.C. 1581, [1982] C.T.C. 2570 (T.R.B.)."

As a result of the latter findings and factors (and the failure of anybody to raise the two notions ("side-bar") discussed above), the case came down to that is was left to be resolved on the basis of whether the exclusionary postamble applied to save the day for the taxpayer. And here, again, what seemingly should have been seen as a slam dunk for the taxpayer turned into a cliffhanger, with the taxpayer barely prevailing.

The first issue discussed is the scope of the triggering words "in connection with"--which the court concludes would cover the issue before the court (that is the services related to a sale of goods or negotiation of a contract)(paragraph 44 and 45).

End of case? Not quite! The Crown (to its continuing discredit in this case) argues two blocks to the conclusion. The exception, CRA argues, only applies to sale of goods by a Canadian--not

to a purchase of goods. The court struggles with that for almost half of page in its judgment (paragraph 46) before (with the assistance of the Quebec Civil Code) rejecting it. (The role of the Civil Code - in the words of the court -- was as follows.

“The word "sale" and not 'purchase' is the generic term used in article 1708 of the Civil Code of Québec to describe the contract "by which a person, the seller, transfers ownership of property to another person, the buyer, for a price in money which the latter obligates himself to pay".”

Had the Crown prevailed on the latter argument, it then would have been relevant that it also argued that the other exception--for payments for services of negotiations of a contract--was not applicable because here such services were only incidental. On this the Court found that "an important part of the services performed by these purchasing agents was 'performed in connection with...the negotiation of a contract'...."And since the Crown did no allocations, and as established by the “bundling cases” – *Farmparts*. (*Grand Toy* - not noted), *Quality* and *Brad-Lea* if the Crown does not allocate , then no part of a Part XIII claim can stand. That would also have killed the Crown's claim.

All in all, a case that should have never been taken to court by the Crown, but yet where it could be said to have barely lost.

Finally, to further underscore the problem with that case, the Crown makes the following incomprehensible claim. The taxpayer is "...using the information provided by the agents and is

paying for their expertise when it purchases from the foreign manufacturers."⁶³ The Court rightly, summarily, rejects this on the basis that it is the sourcing agent that was that in exercising its skill to provide the services (see paragraph ●).

▪ **Other Points to Note**

In the U.S., the court rejected the notion that “royalties” can arise from providing a service. That was the case of the German conductor, Pierre Boulez (*Boulez v. Commissioner*, 83 T.C. 584 (1984)), which saw him conduct an orchestra for the preparation of recordings to be owned and sold by the production company that engaged him. The fees paid to him included a percentage (royalty) of future sales of the recordings.

The taxpayer said that the payments were “royalties” for treaty purposes, and therefore exempt from U.S. tax. The U.S. and the U.S. court took the position that the payments were for services performed in the U.S. The point is that the Court concluded that to have “royalties”, one must be providing use of a property and in this case, Boulez was simply providing a service and therefore the word “royalties” does not go with the performance of services.⁶⁴

If services are picked up under subparagraph (iii), but the services were performed in Canada, how do we reconcile between Part I and Part XIII?

⁶³ In support of that inexplicable statement the Crown cites *United Geophysical*, 61 DTC 1099, *Warsh*, 62 DTC 247, *Burland*, 68 DTC 5220 (SCC), *Western Electric*, 69 DTC 5204 (excerpt) affirmed by SCC, 71 DTC 5068 and *TechTape*, 64 DTC 428).

⁶⁴ For other discussions on this point, see (a) section 125 case....See also OECD Article 12 and the OECD list of 28 e-commerce type of transactions. See also Duncan (Appendix 2).